THE BULGARIAN ECONOMY: ANALYSIS AND OUTLOOK

THE BULGARIAN ECONOMY IN 2007

annual report

AGENCY FOR ECONOMIC ANALYSIS AND FORECASTING

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31 Aksakov Str., Sofia 1000, Bulgaria

Tel.: (+359 2) 9859 56 01, (+359 2) 981 65 97, Fax (+359 2): 981 33 58,
E-mail: aeaf@aeaf.minfin.bg, www.aeaf.minfin.bg

Content

The year of 2007 was the first year of Bulgaria's full-membership in EU. It was imbued with numerous expectations as to faster growth rate in the economy, income and price convergence on the Community average. Almost all developments in the first "European" year have been more or less the outcome of a number of policies on the government agenda in the past few years. The country's macroeconomic stability, consistent economic and prudent fiscal policies, ever-improving institutional environment and continuous cuts in taxes and social insurance contributions have been at the core of the country's strong economic performance, boosted investment activity, higher employment and real income growth. Furthermore, the prospects of EU membership and accession endeavour had been the factors, predetermining Bulgaria's economic development long before the country became a full member of the Community.

For a four year in a row real GDP growth is expected to run well over 6% due mostly to the robust contribution of the service and manufacturing sectors. *Financial intermediation*, *construction*, *retail trade* and *food* were the most vigorously performing industries. At the same time, it should be noted that although posting strong growth, some of the manufacturing industries (e.g. electricity generation and non-ferrous metallurgy) reported a significant decline in export sales in the first half year period of 2007. However, the stronger increase in domestic sales as well as the robust development of a number of industries (e.g. textiles and clothing, machine building, etc) boosted the sector's growth. In addition, a bigger number of industries were now pushing total sales up, implying that the structure of the manufacturing sector is yet to undergo further diversification.

The vigorous investment activity in the country made the strongest contribution to real GDP growth in the first half-year period. Fixed capital formation stepped up by 30% in real terms on a year earlier, and its share within GDP reached 29-30%. Investment expansion was mostly promoted by the current and expected high return on investment. Another factor at work had to do with the need to bring local production into line with the various EU requirements.

The current account deficit over the past few years has been steadily deteriorating due mostly to the worsening country's trade deficit. In the nine months to October, the trade deficit stepped up by 40% on a year earlier, accounting for 81.9% of the current account deficit. However, the size and dynamics of the current account deficit have been a major concern on the government agenda for quite a while. The different current account segments of the balance of payments should be read in close connection with the dynamics of the financial account, as some portion of the trade flows are predetermined and financed by FDI inflows and private foreign debt. In the nine months to October'07, the financial account ran some EUR 7.5 billion worth of a surplus, covering the current account deficit in full. At the same time, foreign direct investment remained the key source of capital inflow on the financial account. Over the same period, FDI into the country totaled EUR 4.1 billion vs. EUR 3 billion on a year earlier.

2007 sustained the labour market upswing of the preceding years. The employed numbers in the economy were steadily rising, whereas unemployment was following a persistent downward trend, stepping down well below 7% in the second half-year period. However, the last couple of years witnessed serious workforce shortages in some business activities. NSI business survey data show that a growing number of builders and property developers have identified labour shortage, of skilled workers including, as a major impediment to their normal operations. At the same time, there was an excess of low-qualified workers to fill the market-place demands for employment.

The above gap in a rapidly developing economy exerts as a rule an upward pressure on wages and unit production costs. Income dynamics in 2007 can be said to be one of the important developments in the economy. Income stepped up at a most robust pace, outstripping productivity. In the nine months to October average wages in the economy rose by 18.2% in nominal terms while posting a record high 8-year real increase of 10.5%. At the same time, productivity in the first six months of 2007 reported a 4.9% real-term rise on a year earlier, running at its highest in the second quarter over the past few years. However, it is noteworthy that labour productivity in the preceding years had tended to pick up at a faster pace compared to real wage growth. Local labour costs in most industries have run a lot lower vis-à-vis EU 25. Therefore, it can be assumed that the 2007 wage and productivity dynamics cannot jeopardize the competitiveness of Bulgarian enterprises, compared to the country's EU trading partners.

The country's fiscal position, as characterized by the huge budget surplus, was stricter and adequate to the economic situation. The robust tax revenue growth is expected to facilitate the achievement of the objectives laid down in the 2007 Government Budget Act and 2006-2009 Convergence Programme as to the size of the budget surplus. The vigorous budget performance was mostly triggered by the strong tax base increase, on the one hand, and some accession-related risks, which lived short of expectations, on the other.

Bank lending in 2007 gained further momentum. As of the end of September, claims on the non-government sector had picked up by 56.1%. Both loans to non-financial organizations and household consumer mortgage credit went on the increase. Unlike the preceding years, however, 2007 credit growth was mostly funded by the higher deposits of non-residents at local banks. At the same time, despite the credit expansion in the economy, the quality of bank credit portfolios has not deteriorated.

The higher global market interest rates in 2007 affected local interest rates too. The interest rates were steadily rising throughout the year, with the most notable increase being reported by the interbank market and with some lag in time by private-sector deposits and loans. As of September, time deposit interest stepped up as high as 4.18% from 3.47% in December'06. On the whole, loan interest rates of different maturity terms and currency followed a distinctly upward trend, though not at the same pace

2007 inflation ran well over the values reported in the preceding years, fuelled mostly by market prices rather than administered price inflation. Market prices stepped up under the impact of the higher global prices of crude oil and fuels, some basic food items as well as the country's accession to EU and income and price convergence on the Community average.

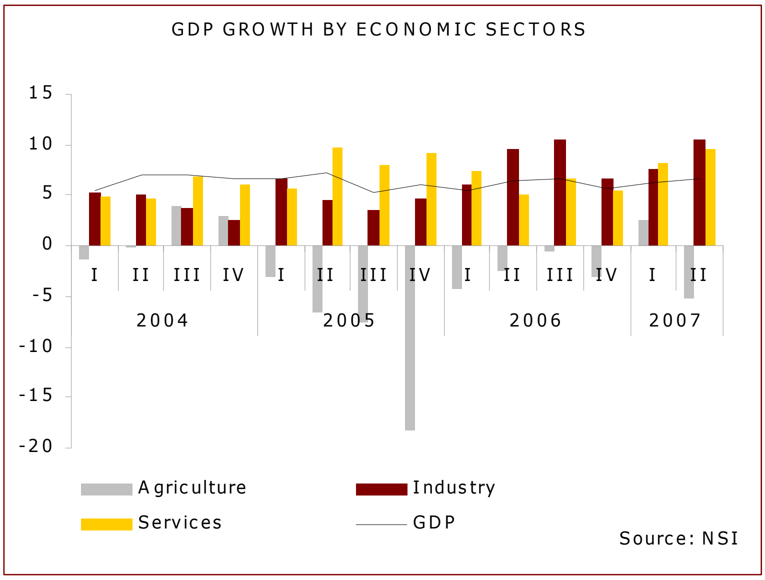
1. Gross domestic product

The stable macroeconomic environment and improving terms of business have been the main factors at work behind the strong country's performance. For ten years in a row the economy has been steadily growing, with GDP growth in the last three years going well over 6%. In the first half-year period of 2007, the indicator hit 6.4%, going 0.4 percentage points up on a year earlier. The expectations are that real GDP growth throughout 2007 will step up well over 6% again.

1.1 – GDP by sector of the economy

The *manufacturing* sector and *services* lied at the core of economic growth in the first half of 2007. *Services* posted the strongest contribution to GDP growth due not only to the high sector's dynamics in the same period but their relatively big share within the total as well. In the first half-year period of 2007, they picked up at a faster pace, with Q1 and Q2 growth amounting to 8.1 and 9.5% respectively. The industries that reported the largest contribution to real GDP growth over the same period were *financial intermediation*, *real estate transactions* and *retail trade*.

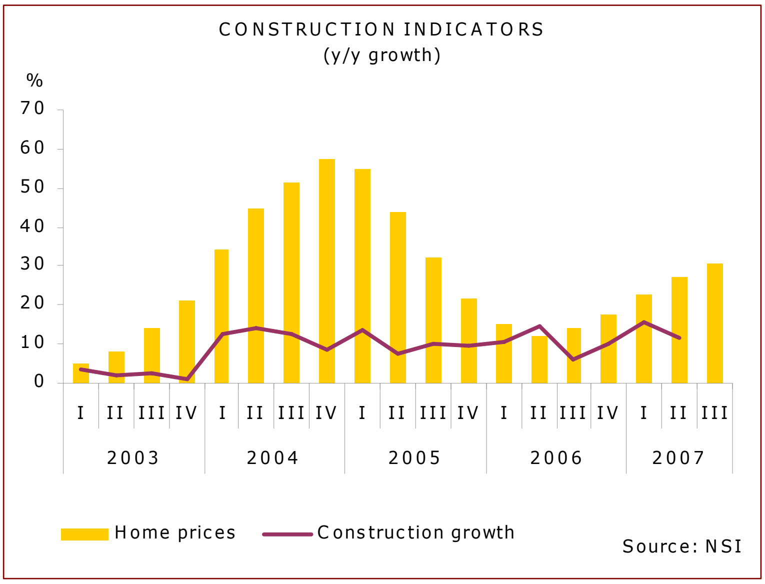
Financial intermediation performed most vigorously, posting a GVA increase of 40.5% due mostly to the strong commercial bank lending (e.g. loan extensions to the private sector rose by 48% on a year earlier vs. 16% in the same period of 2006). Furthermore, note should be also taken of the swift advance of non-banking institutions and high profit margin reported in the local financial markets. And last but not least, it was the restructuring of the banking sector aimed at improving its efficiency that made an important contribution to the above growth.



Real GVA growth in retail trade ran at 9.5% in the first half of 2007, as spurred by the real-term increase in consumption. Nevertheless, 2007 witnessed a certain slowdown as the sector's GVA growth in the preceding three years had varied between 14 and 18% on a six-month basis. Now it stepped down to well below 10%. On the other hand, the past few years have been marked by sizable investment put in the sector and the entry of big chains of supermarkets. The restructuring exercise has helped productivity to improve while bringing in stiffer competition, hence a certain decrease in the profit margin. In addition, the growing number of medium-and large-sized businesses operating in the sector has unveiled much of the illegal retailing in the economy.

The manufacturing industries were the most dynamically developing sector throughout 2006 and the first half of 2007. It grew by 7.6 and 10.5% respectively in the first two quarters due mostly to the processing industries and construction.

Construction carried on picking up at a rather healthy pace, posting a year-on-year increase in GVA of 15.5 and 11.6% in Q1 and Q2. Following the slowdown of the second half of 2006, GVA growth in early 2007 rebounded to its levels in the last three years. Market housing prices followed a similar pattern of dynamics, probably boosting growth in both the construction sector and real estate transactions.



The real estate market disturbances elsewhere in the world (also in hot spots for investors and developers alike) have created strong expectations that the adverse effect may soon be passed on to the local market. Opinions have already been voiced that there is an oversupply of certain types of construction in major metropolitan areas, allowing for some price corrections. Therefore, it can be assumed that the sector will undergo considerable restructuring in the next couple of years, with the share of civic construction in the sector's growth total stepping up at the expense of residential construction. Furthermore, the country will be extended sizable allocations from the EU structural and cohesion funds aimed at supporting mostly civic construction projects.

The processing industries were also performing at a rather strong pace, posting a real GVA rise of 14.5 and 15% respectively in the first and second quarters and hitting an 11-year high. 2007 was also specific in that domestic sales made a larger contribution to growth vis-à-vis export sales. According to NSI data, on a year earlier, 2007 sales in the manufacturing sector went up by 8.5% over the January-September period, with domestic sales advancing by 11.3%, compared to the modest 5.6% increase in export sales.

The decrease in export sales was prompted by the lower exportation of some main commodities that are decisive for the export performance of the manufacturing sector (e.g. oil processing, non-ferrous metals, electricity, heating and water generation and supply, etc.). The closedown of another two power units in Kozludui Atomic Power Station has undermined the exportability of local energy goods affecting the dynamics of the sector's export sales. On the other hand, non-ferrous metal export sales declined as a result of the restructuring of the production capacities available. Exports, however, were expected to recover by the end of the year and become again a leading contributor to the manufacturing sector's strong growth.

Also, it should be noted that 2007 saw a high increase in textile and clothing export sales (15.1% up in the nine months to October on a year earlier). Local producers seem to have overcome the shock of the EU-China agreement on trade liberalization as of 2005 onwards, trying to do their best to re-assert themselves in the EU export markets.

2007 domestic sales dynamics was mostly shaped by the buoyant domestic demand. The strong investment demand boosted growth in manufacturing industries such as machine building (21.6%), optical and electric equipment (9.9%), and transport equipment (28.4%). Furthermore, real growth in consumption was the factor at work behind the vigorous development of the food industry (12.2% up). Food, beverages and tobaccos had the largest contribution to sales growth. The past few years have witnessed huge investment amounts in the food industry, including investment to meet the EU safety requirements. Investment in modern production technologies and quality control and assurance practices has ensured access to new markets and product diversification and pushed export sales further up by 20.5% since the start of the year.

The only sector that carried on manifesting a rather uncertain and hesitant pace of performance was agriculture. In the first half year period of 2007 gross agricultural output stepped up by 1.8% in real terms but the higher production costs led to another drop in GVA. The poor weather conditions made production more expensive and affected crop yields, hence livestock production. According to NSI data, feeding stuff prices went up by over 10% in the six months to July. On the other hand, the gas price dynamics exerted an additional upward pressure on production costs – the price of mineral fertilizers posted a 20% increase in the second quarter. All this entailed a further rise in end-user prices, which however failed to make up for the higher costs in full. Also, as a result of the price increase and poor grain and oleaginous crop yields, Q1 and Q2 grain prices stepped up most robustly by 49 and 44.5% respectively.

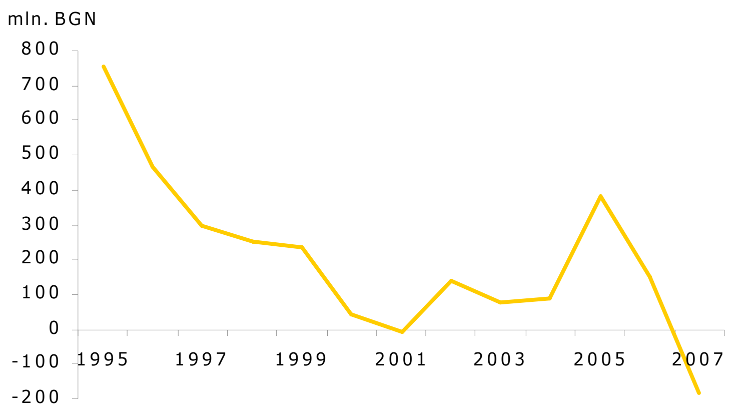
The above developments in crop production did not produce an adverse effect on some of the downstream industries, e.g. the food industry. The dull domestic supply was partly met by way of imports. As a result, the agricultural trade balance worsened. Bulgaria is a net exporter of agricultural products, but the trade balance turned negative in the first half of 2007. Agricultural exports increased by 24.11% but lagged far behind imports (33.99%), leading to a trade deficit

Despite the hesitant growth pace of the past few years, the sector's outlook for the future remains positive because agri-food investment stepped up by about 100% annually. One of the factors boosting investment had to do with SAPARD funds for technological renovation and upgrading of agricultural holdings as well as allocations from other European funds. As of October the contracts concluded with final beneficiaries totaled BGN 1.2 billion under the financing agreements for the whole duration of the instrument. Over half of the investment amounts put up in the measures has been paid up. The strong investment activity is expected to promote productivity in the sector, which now runs three times as low as in the manufacturing industries and services. The number of employed in agriculture accounted for over 20%[1] of the employed total in the economy, given a sector's share in total value added of 7%. Low productivity was also the reason for the low income in the sector running some 40% down on the country's average. On the other hand, another positive tendency at work had to do with decreasing number of animal holdings at the expense of the rising average animal numbers, implying that local agriculture has geared up to production consolidation in an attempt to improve efficiency.

1.2 – GDP by element of final use

Consumption in the first half-year period of 2007 reported a real-term increase that ran close to GDP growth. Total consumption was driven up by the consumer expenditures of the non-government sector. Private consumption[2] stepped up by 7.7%, going up by one percentage point on a year earlier. NPISH spending rose by 10% in real terms, but because of its low weight household consumption growth made a stronger contribution to the total (rising by 7.7% in real terms, too). Income from employment was again the main source of funding final consumer

FOREIGN TRADE BALANCE - AGRICULTURAL GOODS
(January – September)



Source: BNB, AEAF

1. *The data on the employed numbers and labour productivity in the economy have been taken from the system of national accounts, whereas wage statistics draw upon NSI surveys on the employed and wages.*

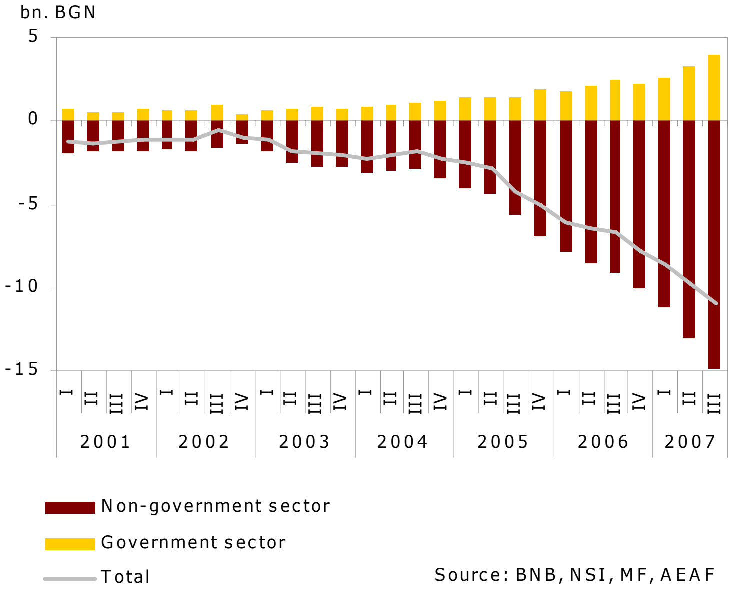
2. *By private consumption is here meant the sum total of final household consumer spending and consumer expenditures of NPISH.*

spending of households. Over half of the growth in spending on market consumption[3] was due to the higher wages in the economy. Early-2007 job creation pushed employment up, which though in a lesser degree compared to income growth in the economy, brought about a certain rise in consumer expenditures.

Consumer loans as well as salaries received elsewhere but spent in the country made a strong positive contribution to market consumption growth in early 2007 of 3.8 and 1.8 percentage points respectively. The increased household income and upbeat expectations for further growth predetermined the strong demand for and extension of consumer loans, hence higher consumption in the economy. On the other hand, loan growth was also bolstered not only by stiff competition, as more and more banks were striving to increase their market share but the removal of the credit growth ceilings as of the beginning of the year as well.

On a year earlier, fixed capital formation in the six months to July rose by 30% in real terms. The huge investment expansion was mostly triggered by the high current and expected rate of return. Corporate income[4] picked up by nearly 16% in nominal terms, given a rise in value added of 13.5%. The enormous profit made by financial intermediation, hotels and restaurants, construction and development and retail trade provided further impetus for capacity enlargement by putting up more investments. In the first half-year period of 2007, fixed capital formation in the above industries stepped up at a much stronger pace compared to the average in the economy. The EU requirements and need for local enterprises to bring their operations into line with the best manufacturing practices were the reason for augmenting investment in the energy generation sector and the processing industries. Total investment in the above businesses accounted for nearly 50% of fixed capital formation growth in the first half of 2007. It follows that nearly half of the total investment amounts were channeled to the sector of tradables, expected to enhance competitiveness in both the domestic and foreign markets and furthermore curtail the negative contribution of foreign trade by strengthening exports and decreasing imports at the expense of some import-replacing industries.

SAVING-INVESTMENT BALANCE
(annualised)



Source: BNB, NSI, MF, AEAF

National savings have been steadily declining since mid-2004, calling in turn for larger foreign financing and leading to higher country's foreign indebtedness. The deficit was mainly spurred by the private sector, as the government sector has generated more savings compared to its investment spending and provided for the investment needs of enterprises. The savings/investment ratio in the government sector covered some 25% of the private-sector deficit, cutting down the imbalance to 19% in the twelve months to June'07. The government sector accounts for 73% of the savings in the economy, spending only about 15% of total investment resources. The weight of

3. Market consumption = final household consumer spending – unincorporated activities – self-sufficiency – imputed rent of owner-occupied dwellings.

4. By corporate income is here meant the gross operating surplus and gross mixed income, as taken from the income account of GDP.

the sector in total investment growth is expected to step up further in 2008, having to do with the growing needs for investment project co-financing under the EU structural and cohesion funds. The projects are mainly aimed at improving the country's infrastructure, producing a healthy effect on the whole economy by reducing costs for enterprises. In 2006 corporate profit provided for investment needs by over 100%. The early-2007 increase in loans, long-term credit in particular, bolstered the share of loan financing in capital investment.

2. External sector

The current account deficit in the last three years has worsened significantly. According to the latest AEAF estimates, the deficit is to run well over 20% of the GDP projections due to the ever-deteriorating trade deficit. In the nine months to October'07 the country's trade deficit had risen by 40% on a year earlier, accounting for 81.9% of the current account deficit.

Foreign trade dynamics in 2007 was largely shaped by the following factors at work: boosted investment activity, global price change, stronger local consumption as fostered by real income growth in the economy and increased bank lending as well as Bulgaria's full membership in EU, which has led to the removal of trade barriers and market expansion.

Imports (CIF) over the January-September period amounted to EUR 15.6 billion, rising by 17.8% on a year earlier due to the stronger importation of raw materials, investment and consumer goods. The importation of investment goods picked up from 17.8 to 25.2%, posting a contribution to total import growth of 6.4 percentage points (with 2.9 percentage points of this share being due to *machinery and equipment* alone). All commodity groups of the import basket but *means of transport* (8% up only) reported a vigorous year-on-year increase. Imports of high value added are expected to improve productivity and enhance the competitiveness of local manufactures. On the one hand, the country's integration into EU common market calls for the implementation of rigid standards of manufacturing coupled with sizable investment amounts. On the other, the enormous FDI inflows into the local economy have given further impetus to the importation of investment goods.

Growth in raw material imports was largely due to *cast iron*, *iron* and *steel* as well as *plastics* and *rubber*. Also the swift advance of the construction sector and all the up- and downstream industries pushed up the importation of iron products, non-alloy steel, metal constructions and spare parts thereof as well as pipes. As for plastics and rubber, pneumatic tyres made a significant contribution of nearly 20% to the group's import growth.

On a year earlier, consumer goods imports in the nine months to October'07 stepped up by 33.3% in nominal terms, as triggered by the stronger importation of food, beverages, tobaccos, furniture and household appliances. Further-

Current Account

Item	January-September			
	2006 in MEUR	**2007** in MEUR	**Change** in absolute terms	**Change** in %
Current account	-2100.2	-3873.5	-1773.3	84.4
Exports (FOB)	8923.9	9729.1	805.2	9.0
Imports (FOB)	-12552.2	-14810.2	-2258.0	18.0
Trade balance	-3628.2	-5081.1	-1452.9	40.0
Services (credit)	3366.6	3744.1	377.5	11.2
Services (debit)	-2368.6	-2576.8	-208.2	8.8
Services (net)	998.0	1167.3	169.3	17.0
Income (net)	35.0	-202.6	-237.6	-678.9
Transfers (net)	495.1	243.0	-252.1	-50.9

Source: AEAF, BNB

more, the above increase was, above all, prompted by the higher consumption in the economy and price rise in some basic food items on the global markets.

Crude oil imports over the January-September period remained almost unchanged on a year earlier. In early 2007 imports reported a significant shrinkage only to rebound ever afterwards in volume terms. Also, a key oil plant underwent substantial restructuring, entailing some downscaling in production and hence lower oil imports.

Export and Import of Goods						
Commodity groups	January-September					
	Import of goods (CIF)			Export of goods		
	2006	2007	Change	2006	2007	Change
	in MEUR	in MEUR	%	in MEUR	in MEUR	%
Consumer goods	1885.5	2513.1	33.3	2173.5	2374.1	9.2
Raw materials	4805.9	5772.7	20.1	3968.6	4508.9	13.6
Investment goods	3359.1	4205.3	25.2	1315.0	1521.0	15.7
Energy goods	3081.2	3061.6	-0.6	1466.9	1325.2	-9.7
Total	13200.1	15552.8	17.8	8923.9	9729.1	9.0

Source: AEAF, BNB

Having risen by MEUR 805.01 or 9% on a year earlier, exports over the January-September period amounted to EUR 9.7 billion. The above growth was mostly triggered by the vigorous export performance of raw materials, with the strongest contribution being posted by cast iron, iron and steel, and textiles. Flat-rolled iron products and non-alloyed steel accounted for nearly 60% of the increased cast iron, iron and steel exports. On the other hand, the exportation of man-made staple fibres and knitted fabrics was responsible for the robust growth in textile exports. At the same time, non-ferrous metal exports shrank by 2.4%. The two-month closedown of a local copper plant for a major overhaul led to a drop in non-ferrous metal production, entailing in turn a drop in unrefined copper exports over the April-June period. In the second half-year-period of 2007, however, exports rebounded.

In the nine months to October oil product exports contracted by 9.5% as a result of the restructuring of the production capacities available. In the first half of 2007 the oil price in the global markets ran lower than in the same period of 2006, failing, however, to affect significantly oil trade. In September and October oil prices went on the increase, stepping up well over the levels in the same months on a year earlier due to robust global oil demand and cheaper US dollar to the EUR. In addition, the downscaling of power generation at Kozludui Atomic Power Station induced an 80% decline in exports.

Revenues from investment goods exports over the January-September'07 period picked up by 15.7% vs. 27.3% on a year earlier. The slowdown was prompted by *means* of *transport* alone, which reported a 50% plunge in the export sales of ships and boats, relative to the same period of 2006. At the same time, revenues from the remaining groups of investment goods carried on advancing at a healthy pace of over 20%.

As for the exportation of consumer goods, clothing items and footwear reported a 5.2% drop. At the same time, export sales went up by 24%. Most probably, the bulk of trade was carried out by numerous small companies, which did not meet the threshold requirement in the supplementary declarations on dispatches to the EU and were thus unregistered by the new Intrastat system reporting trade flow statistics in the Community. It should be also noted that EU member states are the main trading partner of Bulgaria and a major export destination for the clothing and footwear industry.

Over the January-September period, exports to EU accounted for 61.5% of total exports vs. 61.1% on a year earlier. The relative share of exports to Asia contracted by

1.2 percentage points at the expense of the 0.9 percentage point rise in the weight of exports to Russia within the total. EU imports into the country represented 51.7% of total imports vs. 50.4% in the same period of 2006. The relative shares of imports from Russia and the USA stepped down by 1.5 percentage points, whereas the relative weight of imports from the Balkan countries, Asia and EU-10 in total imports advanced by 2, 1.1 and 1 percentage points respectively.

The net service balance in the nine months to October amounted to EUR 1.2 billion, posting a MEUR 169.4 worth of a rise on a year earlier. Revenues from tourism were responsible for over 50% of the revenue total from services, making the strongest contribution to the higher net balance on services in the period surveyed. 2006 saw a certain growth slowdown in the revenue amounts from tourism as result of the stronger competition in the region, low service quality and rampant construction in many resorts. In 2007, however, the number of holiday makers visiting Bulgaria stepped up, bringing in a 10.9% year-on-year increase in receipts due mostly to the country's accession to EU and free movement of people in the Community. Besides, the swift advance of low-cost airlines in the local market added to the competitiveness of the country as a holiday destination.

Both net income and net current transfers enjoyed a rather large share in the ever-deteriorating current account balance over the January-September period. The income deficit worth MEUR 202.7 (vs. MEUR 35 of a surplus in the same period of 2006) was due to the 69% year-on-year rise in payments on foreign direct investment. This was only partially covered by the compensations of employees, which carried on growing steadily (22%), promoted by the improved job opportunities for Bulgarian citizens abroad.

Net current transfers amounted to MEUR 243, running twice as low as in the same period of 2006. Budget transfers to other countries went up significantly, with some 60% of them being the regular country's contribution to the EU budget worth MEUR 208. Another reason for the worsening balance on transfers had to do with the rising payments on private-sector transfers.

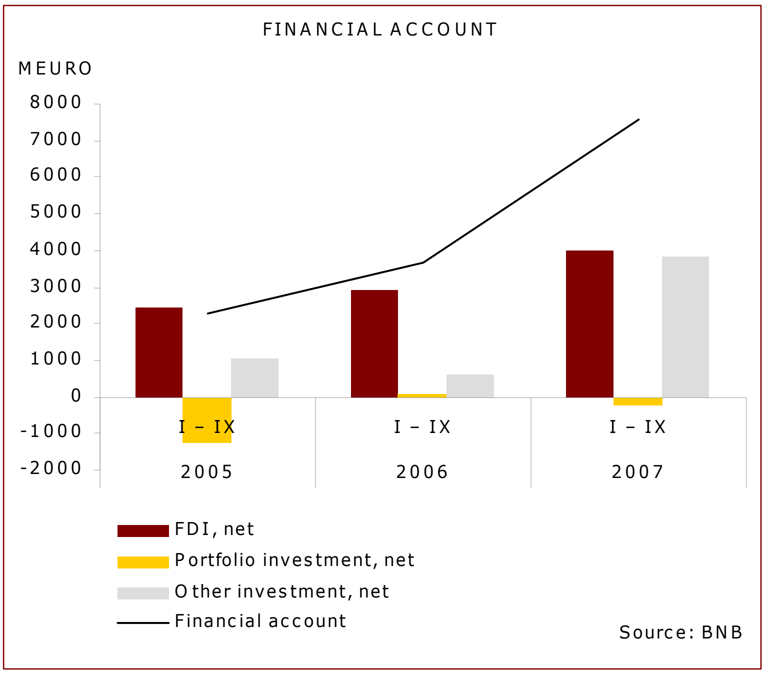
2.1 – Financing the current account

The size and dynamics of the current account deficit have been a major concern on the government agenda for some time. However, the different current account items should be read in close connection with the dynamics of the financial account, as some portion of the trade flows have been generated and financed by FDI inflows and private-sector foreign debt.

In the nine months to October the financial account ran a surplus worth EUR 7.5 billion, covering the current account deficit in full. The flows on the financial account ran twice as high as in the same period of 2006, with the most significant change being reported by local bank deposits abroad (which went on the decrease after a steady rise in 2006).

In July and August local bank deposits abroad grew by MEUR 471.6 due to the liquidity demand on the part of mother banks having to do with the financial crisis worldwide. In September, however, they stepped down by MEUR 669.7 as result of the increased minimum required reserves (from 8 to 12%). The measure had most probably forced banks to decrease their deposits abroad and put in the amounts required to maintain lending. On the other hand, non-resident deposits at local banks reported a most robust rise of MEUR 856.8 vs. MEUR 351.7 on a year earlier. The sizable inflows into the country had to do with the relatively high rate of return offered by local commercial banks.

FDI were again the key source of capital inflows on the financial account. In the nine months to October FDI amounted to EUR 4.1 billion, compared to EUR 3 billion on a year earlier. The sizable foreign capital inflows are considered to be the main reason for the ever-growing current account deficit. On the one hand, they lead to higher payments on direct investment in the income account. On the other, they boost the importation of investment goods, pushing up the trade deficit even higher. The expectations are that FDI throughout 2007 will go up as high as EUR 5 billion, with foreign capital inflows rising at a slower pace.



Throughout January to October, share capital stepped up to 63% of total foreign investment inflows into the country vs. 42% on a year earlier wholly at the expense of intra-company indebtedness. Nevertheless, the structure of FDI attracted may undergo some adjustments following the upcoming revisions.

FDI inflows in the period under review were mostly focused on real estate transactions, renting and business services, financial intermediation, and construction and development. Financial intermediation made the strongest contribution to investment growth. At the same time, investment injections in the processing industries ran significantly lower than in 2006.

The largest FDI amounts over the January-September period were attracted from EU member states, Great Britain, Belgium and Austria in particular. The factors that promoted foreign investment had to do with the comparatively high return, favourable investment climate, the strongly performing economy, market expansion and growing investor confidence following the country's accession to the EU.

The huge current account deficit, which amounted to EUR 3.9 billion in the nine months to October'07, has raised a serious question as to the sustainability of the country's external position the analysis of which draws upon a number of factors, having to do with assessments of solvency and liquidity in the economy.[5]

The huge current account deficit has been above all the outcome of some fundamental factors at work. It reflects the scarcity of national savings to provide for the boosted investment activity in the economy. Investments have grown at a faster pace than savings. Since 2001 savings have held steady at 16-17% of GDP, whereas investments stepped up from 21% to nearly 35% in the nine months to October 2007.

Financial openness rose from 5% of GDP in 2001 to 37% as of the end of October'07, ensuring coverage of the current account deficit of over 100%. Until 2006 net FDI had accounted for about 80% of the financial account balance. Portfolio investments had amounted to some 2%, and the remaining flows were mainly net investment. A similar structure of the net capital inflows into the economy is indicative of the level of sustainability of current account deficit financing. However, the nine months to October witnessed a higher potential risk of fast growing outflows from the country having to do with the increased share of debt financing in the financial account balance to 51%. Moreover, the above data are only preliminary, as the enormous financial inflows have been generated as a result of the response of commercial banks to the higher mini-

5. Milesi-Ferretti, G.M., A. Razin, Current Account Sustainability, 1996.

mum reserve requirements and any further data revision will bring about significant changes in the structure of foreign liabilities in the period surveyed.

Despite the high current ratio (195% over the January-October 2007 period), ensuring full deficit coverage by way of net capital flows in the future may be jeopardized by the rapidly growing private foreign debt, undermining in turn the net investment position. Private non-guaranteed foreign debt went up from 14.7% of GDP in 2001 to 62% in late 2006 and further up to a robust 79% as of the end of September, whereas the country's net investment position increased from 29% of GDP to 53 and 72% in the corresponding periods.

In the medium term, the current account deficit is expected to steady at its current levels. As there are stable enough buffers reducing solvency and liquidity risks in the economy, the current account deficit does not at present jeopardize the country's macroeconomic stability and growth. Nevertheless, measures should be taken to enhance its sustainability facilitating the diversification of the product structure of trade, improvement of efficiency of both FDI and public finance, and the implementation of consistent economic policies aimed at long-term strategic objectives.

3. Labour market

3.1 – Employment and the jobless rate

2007 sustained the labour market upswing of the past few years. The unemployed numbers were steadily declining, whereas the unemployment rate stepped down well below 7% in the second half of the year.

According to NSI labour force survey (LFS) data, the number of unemployed was decreasing at a faster pace to 248.5 thousand on average in the nine months to October. The jobless rate ran at 7.1%, reporting a 2 percentage drop on a year earlier. The administrative statistics of the Employment Agency provided further evidence of the downturn unemployment trend in the economy. Registered unemployment reached 6.7% as of the end of October, hitting a 16-year low.

The jobless rate has stepped down due mainly to the growing employment in the country having to do with the stronger labour demand and primary market job creation. In the three quarters to October average employed numbers[6] increased by 4.6% on a year earlier.

Contributions to Unemployment Change*

Year	Unemployment Rate (change, p.p.)	Working-age Population (change, %)	Participation Rate (change, %)	Employment (change, %)
	≈	+	+	-
2005	-2.0	-0.4	0.6	2.4
2006	-1.2	-0.8	3.9	4.3
I-IX 2007	-2.0	-0.7	2.9	4.5

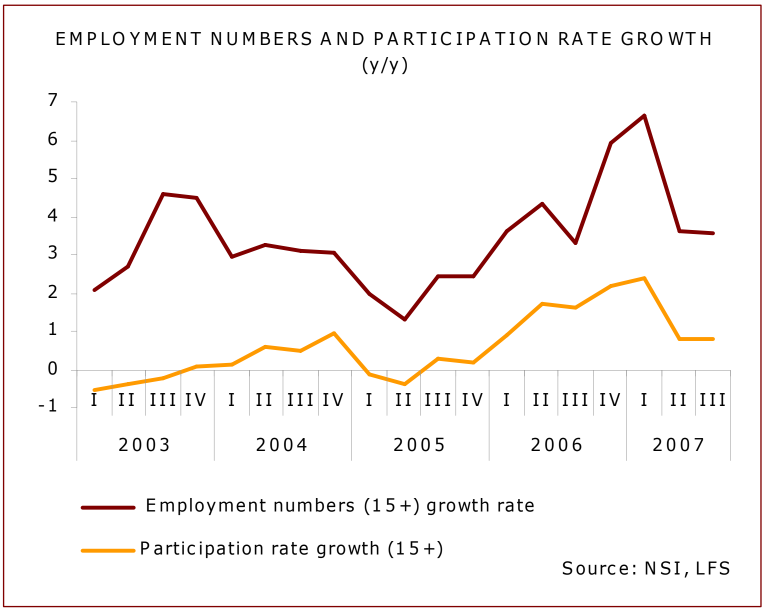
Source: European Commission, AEAF

* Contributions to unemployment changes are calculated accordingly to European Commission methodology in the report "Labour market and wage developments in 2006, with special focus on relative unit labour costs developments in the euro area", European Economy 2007, № 4). The change in unemployment rate approximates the sum of the % change in working-age population and the participation rate minus the % change in employment . Calculations are based on the LFS figures for the age group of 15 to 64.

Private-sector job creation and the stronger participation rate have pushed 12-month employment growth even higher. LFS data indicate that the number of private-sector employed stepped up by about 166 thousand while the participation rate[7] advanced by

6. According to Labour Force Survey data, age group 15+.

7. Falling within the age group of 15 and over.



1.3 points. The scope of the subsidized employment programmes was further narrowed and their effect on the labour market developments was waning. The number of employed under the active labour market measures and programmes of the government amounted to 75.4 thousand on a monthly average in the January-September period, going down by 21.5% on a year earlier.[8] The effect of unveiling grey-economy employment triggered by the 6 percentage point decrease in the social security burden in 2006 was now fading away.

Posting an increase of 30.5%, the construction sector had the largest contribution to employment growth. The vigorous development of the businesses was also related to job creation and stronger labour demand. The second quarter saw some slowdown in investment growth in the industry, expected to result in a slower pace in job creation. The employed numbers went on the increase in the first quarter while steadily declining in the second and third quarters. And yet, nine-month employment in the sector ran well above its levels on a year earlier, reporting a most vigorous rise in the last quarter due probably to the effect of unveiling a large number of the unofficially unemployed.

Real estate transactions, *renting* and *business services* made a stronger contribution to total employment growth in the economy, triggered by the high real estate demand. On the other hand, employment in *retail trade* remained high in the nine months to October'07, though decelerating on a year earlier (3.5% on average in the nine months to October vs. 10.9% in the same period of 2006) as a result, first of the decrease in investments. And second, the effect of unveiling unofficial employment was now wearing out, failing to affect the indicator's dynamics the way it had done in 2006.

The processing industries doubled their contribution to total employment growth in the economy due to the rising employed numbers. They were also the industries attracting the most investment in the nine months to October. In addition, the sector's employment dynamics was fully shaped by the dynamics of the business activity there in 2007.

The improved job opportunities, together with the larger labour force cohorts led to a higher participation rate in the economy. The discouraged numbers in the nine months to October declined by 72.6 thousand on a year earlier. Furthermore, the past few years have witnessed noticeable labour force shortages in some industries. As NSI business survey data have indicated, the share of entrepreneurs in the construction and manufacturing sectors, identifying labour force shortages, of skilled workers including, as a major impediment to their operations, has gone on the increase.

LFS data have, too, provided further evidence that labour force shortages have become a pressing problem. In the aggregate, the unemployed and discouraged (the out-of-labour force cohort able to join the work force to meet the stronger labour demand in the economy) hold poorer vocational and educational qualifications compared to the employed. Besides, the supply of labour of low education (elementary and lower secondary education) is stronger than demand, often resulting in skill mismatches.

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8. Employment Agency data.

Share of Employed and of Unemployed and Discouraged by Degree of Education

Year	Share of employed by degree of education in total employment numbers					Share of unemployed and discouraged by degree of education in total unemployment and discouraged numbers				
	1	2	3	4	5	1	2	3	4	5
2004	25.9	40.1	15.4	16	2.6	8.5	31.2	13.4	32.9	14
2005	25.6	41.2	15.3	15.6	2.4	7.6	30.1	13.5	33.3	15.4
2006	25.5	41.2	17	14.7	1.6	8.6	28.3	14.3	34.9	13.8
2007I-VI	25.9	41.6	18.3	12.5	1.7	7.4	28.9	15.7	33.7	14.3

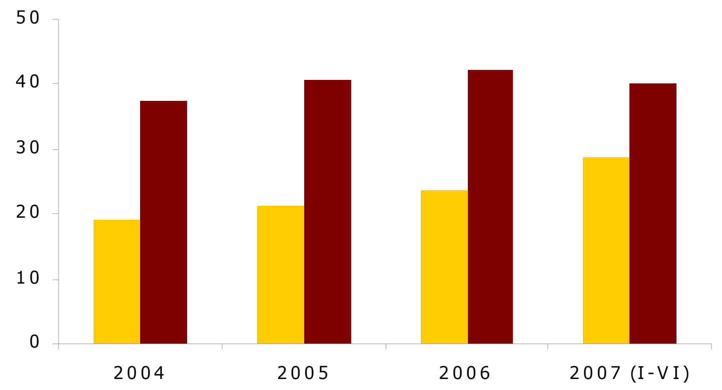
Source: LFS

1 – Degrees "Bachelor", "Master", "Doctor", "Specialist"
2 – Secondary vocational
3 – Secondary general
4 – Lower secondary
5 – Primary or lower

Therefore, taking for granted that the structure of the new jobs created is more or less the same as the structure of the jobs already available (with new job creation likely to pose stricter vocational and professional qualification requirements having to do with the swift advance of new technologies), the skill gap in the first half-year period alone was roughly estimated at 33.9%[9], given the current jobless and discouraged numbers in the economy. It follows that economic policies will have to face a major challenge, i.e. promote conditions for rewarding employment for the out-of-labour force cohorts to join the country's work force.

In a mid-tem perspective, both employment and the jobless rate are expected to sustain the positive tendencies of performance of the past few years, underpinned by the stable economic growth anticipated. Despite the unfavorable demographic developments and expected decrease in the working-age population, the employed numbers in the economy will carry on rising, at a slower pace on a 12-month basis, though. Employment growth will be mainly boosted by the higher participation rate of both companies and individuals. The lower social security burden of October 2007 is expected to further promote job creation, as the decreased labour costs will give employers a stronger stimulus to declare income and informal market employment unreported so far. Nevertheless, the effect of the lower social security burden on unveiling unofficial employment will be steadily wearing out. A number of administrative measures have been undertaken in the last couple of years to control informal market employment by requiring employers to register labour contracts. Others have aimed at improving the country's business environment. Ever since 2001, the social security burden has stepped down by 12 percentage points. However, drawing upon a major assumption that the impact of the measures on unveiling grey economy statistics was strongest in the year they took effect, it can be considered that some part of the informal market

DISCREPANCY BETWEEN DEMAND AND SUPPLY OF LABOUR BY EDUCATION



Source: Own calculations based on NSI data and Rutkowski's paper

9. Estimates of skill mismatches and the skill gap in the economy rely on a policy research paper by Jan Ru Estimates of skill mismatches and the skill gap in the economy rely on a policy research paper by Jan Rutkowski "Why is Unemployment so High in Bulgaria?", World Bank Policy Research Working Paper 3017, April 2003.

employment has been brought into light, or put in other words, the "unveiling" potential of the measures has gone on the wane[10]. The flat personal income tax rate effective from 2008 is expected to boost disposable income growth from employment, and hence make both labour demand and the participation rate in the economy stronger. At the same time, skill mismatches (among the jobless and discouraged ranks) may check employment growth, i.e. it will hamper the fast increase in the employed numbers. Also, job creation is likely to outstrip job occupation, exerting a further downward pressure on nominal wage growth.

One of the possible solutions to the skill gap problem is to hire workforce from elsewhere. 2007 saw the drafting of a national strategy on the country's labour migration policies. However, so that the above is effectively monitored, there should be in place a nationwide system of data gathering and analysis of the immigration patterns of foreign workers, which is highly unlikely to take place in the short run. At the same time, as experience gained by other member states shows if the economic benefits of immigration are to be fully absorbed, more selective policies should therefore be sought after, coupled with adequate measures aimed at the social integration of foreign workers (e.g. active labour market measures, bilingual education, educational support, etc.). In addition, to meet employers' demand by the end of 2009, the Ministry of Labour and Social Policies and Ministry of Education and Science will have to implement a nationwide system of monitoring and recording workforce flows, having a specific qualification and vocational profile. All this will gear other government policies up to the most pressing labour market concerns, ensuring a close link between vocational training programmes and market demands.

Therefore, labour market policies should put greater emphasis on vocational training to overcome the current problems. Having steadily declined over the past few years, the country's unemployment rate has reached levels that are comparable with the EU-25 average. With a view to the new market demands, the government should take a new approach to its employment promotion policies. In he last months of 2007, the Labour Ministry announced its intentions to carry out a major change, shifting the policy focus to vocational training and professional qualification programmes, traineeships including, rather than promoting subsidized employment. Furthermore, employers should, too, invest more actively in the quality of labour they hire. All this will make them gear to the imperatives of economic development and improve their competitiveness, given persistent workforce shortages.

In order to boost labour supply the government undertook a number of steps aimed at applying atypical forms of employment by drafting legal requirements for temporary agency work effective from the beginning of 2008. The atypical forms of employment also include fixed-term labour contracts and part-time work. The country's legislation having to do with hiring labour and flexible working time has been seriously criticized by many international institutions. At the same time, at a national level many and contradictory opinions have been voiced as to whether the specific labour legislation is a major impediment to the flexibility of working time. However, this is a larger issue that is open to further and more intense discussion between the government and its social partners

The tighter controls on the social aid system as of 2008 are expected to have a healthy effect on labour supply. These controls now include another measure providing for a one-year drop-out spell of working-age jobless who have been entitled to social aid in the preceding 18 months.

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10. Note should be also taken of the assumption that the number of grey-economy employed numbers tends to remain unchanged.

3.2 – Wages

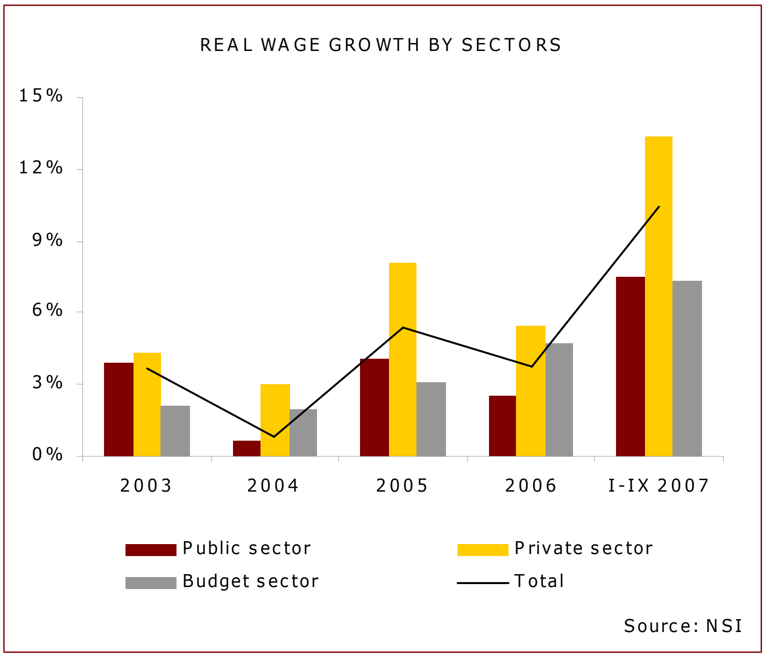
Income dynamics can be identified as one of the important developments in the economy in 2007. Income posted a record high increase, outstripping productivity and posing a number of questions having to do with wage sustainability in the medium term. The above development is also important in that it has affected other key indicators and underlying economic policies.

In the nine months to October'07 average wages[11] reported an overall nominal and real-term rise of 18.2 and 10.5% respectively, hitting an eight-year high. Wage growth was mainly driven by the private sector, where the indicator stepped up by 21.2% in nominal terms and 13.3% in real terms on a year earlier. The market segments characterized by lower relative wages, e.g. *retail trade*, *construction*, and *food* and *textiles*, made the strongest contribution to the higher labour costs. Furthermore, data on fixed capital formation have indicated that these were also the most vigorously performing industries in 2007. They also encompass low-qualified workforce, implying that the investment made helped improve productivity relatively fast, which has in turn affected average wages in these industries. On the other hand, labour market estimates show that labour supply has come under pressure, having to do with skill mismatches (triggering a rise in wages and unit production costs). Furthermore, private-sector wage growth was prompted by the lower social security burden, as result of which much of the underground economy income has been unveiled and reported by official statistics. This assumption is further supported by data on revenues from social insurance contributions in the first half-year period of 2007. The overperformance of the revenue item was triggered by the 12% year-on-year increase in the average monthly insured income.

Another sector making a significant contribution to average wage growth was *transport*. The robust indicator's performance had to do with the sizable investment injections, stronger demand for transport services, unveiling of unreported income, and last bit not least, the administrative rise in income in some regions in 2007.

Financial intermediation also enjoyed a significant weight in average wage growth in the economy, as productivity there has again run one of the highest.

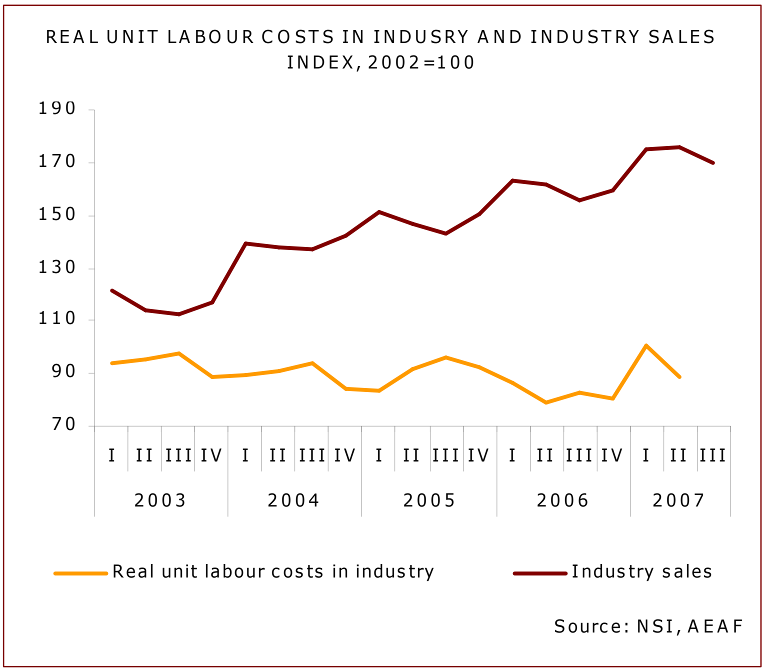
Public-sector wages went on the increase, too, but did not exert an extra upward pressure on average wages in the economy. On a year earlier, average wages in the public sector in the nine months to October advanced by 15.2 and 7.6% in nominal and real terms respectively. The existing social tension having to do with the higher pay demands of some professions has failed to affect the country's wage dynamics., as evident from data reported in the January-September period: the contribution of public-sector wages to total wage growth amounted to less than 25%.



11. *Preliminary estimates of enterprise surveys.*

Labour productivity[12] in the first half-year period of 2007 grew by 4.9% on a 12-month basis, hitting a record high in the second quarter. *Financial intermediation* and the processing industries made the strongest contribution to this growth, reporting a year-on-year real-term change of 25.6 and 11.8% respectively. They also accounted for nearly 85% of the higher labour productivity in the economy. On an annual basis, real growth in productivity in retail trade was also up at 6.5%. The changes in labour productivity discerned in the first half-year period matched largely the strong performance of the industries. In *financial intermediation*, for example, the increase in productivity was by and large associated with the market expansion since the start of the year – the employed numbers registered a fivefold rise, whereas gross value added ran eight times higher. As for the processing industries and retail trade, productivity picked up as a result of restructuring and optimization while the strong pace of increase in value added was coupled with a slowdown in the employment rate on a 12-month basis.

Income dynamics and labour productivity over the January-June'07 period has led to increased unit labour costs[13]. In the first half of the year the indicator stepped up by 7% on an annual basis. However, it is still too early to say that this is a sign of some loss of competitiveness.



The above assumption is further supported by sales data in the ten months to November.

A comparison of the change in unit labour costs in the manufacturing sector[14] and sales since the start of 2007 has indicated that the increase in unit labour costs resulted in a sluggish sales growth alone. Nevertheless, sales growth ran well over its 2006 level, implying that the sector of tradables has retained its competitiveness.

Besides, the analysis of competitiveness should also take account of the fact that unveiling the grey economy and reporting informal market employment by the official sources have contributed to the slower dynamics of officially reported productivity in the economy, other things being equal. It follows that the slower real growth in productivity in 2007 vis-à-vis real wages was partly due to inadequate estimations rather than to the developments underway alone.

It is also important that labour productivity in the preceding years had tended to outstrip wage growth. Therefore if we assume that the two indicators will perform in more or less the same pattern in the long term, wages are likely to step up at a stronger pace vis-à-vis productivity over time, making up for the slowdown in some of the years.

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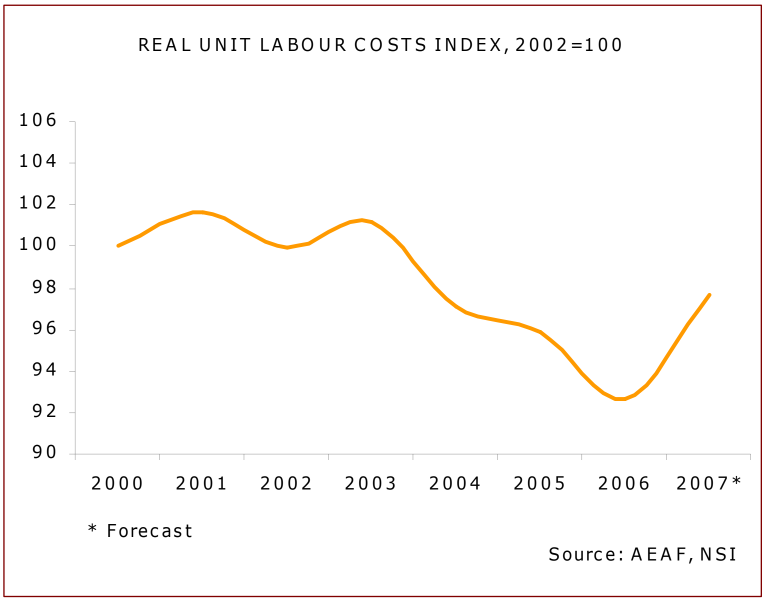
12. Labour productivity is estimated as the ratio of GDP at constant prices to the number of employed according to the System of National Accounts.

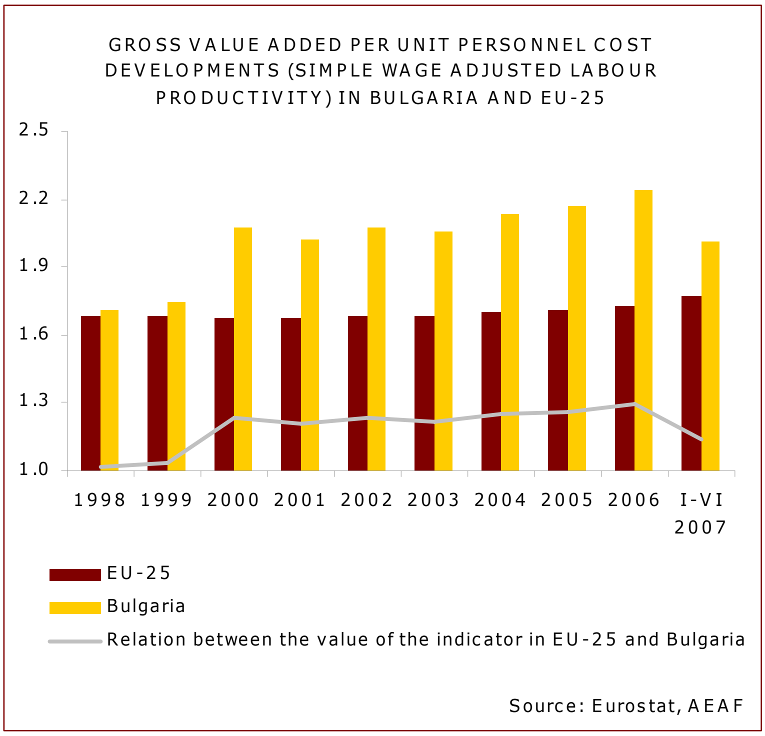
13. AEAF own estimations based on employee compensations, gross value added and the employed numbers according to the System of National Accounts data.

14. This includes the extraction and mining industries, the processing industries and electricity generation and supply.



In conclusion, it is noteworthy that data on productivity, as compared to labour costs, indicate that the ratio in the past few years has been more favourable vis-à-vis the ratio in EU-25[15]. Having run very close to EU-25 in 1998 and 1999, the indicator[16] in the local economy has varied between 1.2 - 1.3, hitting a high in 2006 (1.3) since 2000. Despite the growing concern over the significant income growth since the start of 2007, the indicator in the first half-year period remained well over the EU average (1.14).

The above tendency was discerned in most of the industries. GVA per init personal costs[17] vis-a-vis EU-25 ran highest in 2004 in *rubber and plastics* (1.42), *other non-metal mineral raw materials* (1.81), *electric machinery and apparatus* (1.29), *radio and TV equipment* (1.42), and *transport*, *warehouse keeping*, *storage and logistics*, *and communications* (1.29). Furthermore, compared to EU-25 again, most local industries enjoyed the same advantage as regards profitability: textiles (1.61), other non-metal mineral raw materials (1.36), radio and TV equipment (2.05), vehicles and trailers (2.13), transport, warehouse keeping, storage and logistics and communications (1.28). All this considered, it is still too early to say that the early-2007 pay rise will undermine the competitiveness of local manufacturers compared to the country's European trading partners.



Government income policies are not expected to put the wage levels under pressure, ensuring sustainable economic growth. The mid-term fiscal framework measures provide for a smooth decrease in the direct tax and social security burden as well as stepwise pay hikes in the budgetary sector. Effective from the beginning of 2008, a 10% flat tax rate will be applied to personal income. Besides, 2008 is also to see a reallocation of the total social security burden by bringing another 5 percentage point pressure to bear on employees. Nevertheless, the average disposable income from employment is to step up by about a percentage point, compared to the scenario accommodating the current personal income tax scale.

15. The comparison between Bulgaria and EU-25 is based on data on GVA per unit personal costs rather than unit production costs, which explains the absence of statistics by industry about EU-25.

16. AEAF own estimates relying on data from Eurostat and the System of National Accounts.

17. According to Eurostat data, Structural Business Statistics.

Productivity and profitability						
	Wage adjusted labour productivity*			Gross operating rate**		
	EU25	Bulgaria	Bulgaria	EU25	Bulgaria	Bulgaria
NACE	**2004**	**2004**	**2005**	**2004**	**2004**	**2005**
Mining and quarrying	340	209.7	251	26.8	22.8	28.7
Manufacturing	146	187.2	205	9.5	9.2	10.1
Electricity, gas and water supply	280	277.9	287.6	16.5	15.2	15.4
Construction	122.5	158.7	:	11.7	7	:
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	142.5	175.4	195.9	6.1	3.5	3.9
Hotels and restaurants	126.3	160.3	171.7	15.5	14.6	16.3
Transport, storage and communication	164.3	212.4	205.9	18.1	23.2	20.9
Real estate, renting and business activities	150.8	155.4	162.9	22.8	14.6	16.5

Source: Eurostat, AEAF

* Gross value added per unit personnel cost

** Gross operating surplus/turnover

As for minimum wages, the 2008 budget has provided for a 22% increase. It should be also noted that minimum wages will now be treated as taxable income unlike the preceding years. As a result, the minimum disposable income will go up by 10% on an annual basis and will therefore not exceed the nominal GDP growth expected. In addition, from the point of view of competitiveness, the measure foreseen is not expected to exert any pressure on labour costs due to the lower social security contributions payable and reallocated employer/employee ratio burden.

Average budgetary-sector wages will carry on changing in a strong and sustainable manner in line with the country's economic performance. Mid-term wage growth is estimated at about 10%, with government policies in the next couple of years being targeted at staff downscaling. Other measures foresee a faster growth rate of productivity vs. wages that is expected to influence wage bargaining in the private sector. This will be measured by way of an index taking into account the dynamics of labour productivity, inflation and other indicators reflecting the state of affairs in specific industries.

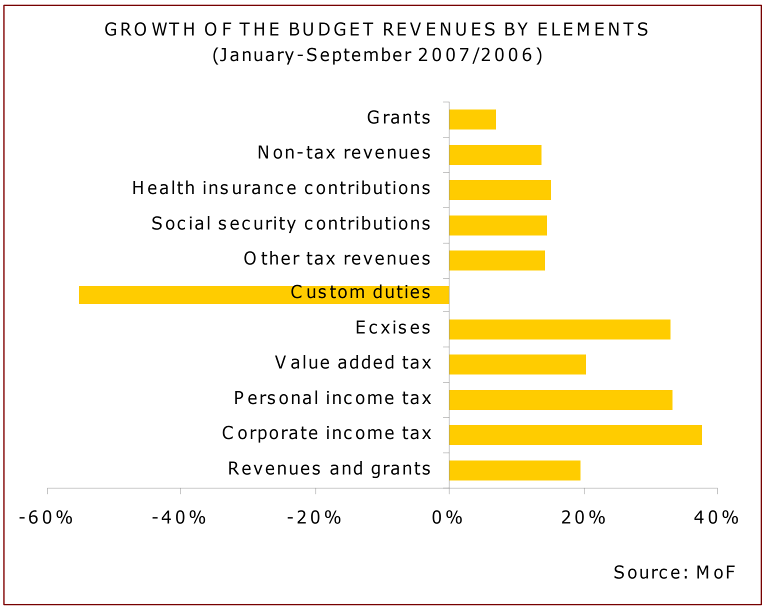
4. Fiscal sector

The fiscal position, as gauged by the size of the budget surplus in 2007, was even stricter than in 2006 and adequate to the economic situation. The robust tax revenue growth led to an increase of over 6% in the positive balance as a percentage of GDP over the January-September period. The surplus stepped up as high as BGN 3.4 billion in nominal terms, going up most vigorously by 59.1% on a year earlier. The strong budget performance was mainly triggered by two factors at work, viz. the significant increase in the tax base throughout the year and lower than expected risk associated with the country's accession to EU.

4.1 – Tax policies

Total consolidated budget revenues in the nine months to October rose by 19.5%, as prompted by the 22.9% growth in tax revenues. The country's accession to the Community ushered a number of amendments to indirect taxation aimed at aligning it with the acquis. The new VAT regime resulted in an anticipated early-year revenue drop, which was by and large made up for in the following months. The high import volumes lied at the core of the year-on-year VAT revenue growth of 20.3% in the January-September period, accounting for 77% of the 2007 budget projections.

Higher than expected inflation in the economy exerted an extra upward pressure on revenues. According to AEAF estimates, CPI, the impact of which was strongest in the third quarter with a contribution of about 32%, was responsible for some 13% of VAT revenue growth.



The increased excise duty rates and broadened range of duty-levied goods enjoyed a significant share in the 33.1% increase in receipts as of the end of September. Their performance accounted for 76.1% of the 2007 Budget Act projections. The removal of customs duties for the EU member states and implementation of the common customs policies towards third countries had a rather adverse effect on revenues, entailing a 55.4% shrinkage in the nine months to October.

As for direct taxes, the burden was further reduced, promoting investment in the economy and pushing production and real household income up. The corporate income rate was cut down to one of the lowest EU levels from 15 to 10%. All this resulted in a broadened tax base, which together with the robust business activity led to sizable revenue amounts. In the nine months to October they had run well over the 2007 budget projections, posting a strong year-on-year increase of 37.7%.

The personal income tax amendments in effect from the start of the year were mainly aimed at reducing the tax burden and raising real household income. Non-taxable income stepped up from BGN 180 to 200, which according to AEAF estimates made a 0.4 point contribution to the tax burden decrease. At preliminary estimate, the effect of the change along with the increased tax relief for children amounted to BGN 120 million worth of a revenue loss for the budget. Instead, personal income tax revenues reported a rather strong rise of 33.2% due mostly to higher income from employment having to do with the nominal wage increase in the year and employment growth in a lesser degree. Foreign persons' income was now encompassed by the Personal Income Tax Act, replacing the withholding tax requirements of the Corporate Income Tax Act. The estimated effect of the amendment was worth BGN 46.8 million as of the end of September, making a 15% contribution to total personal income revenue growth.

Revenues from social security contributions were following an upward trend throughout the year, stepping up by 14.6% in the period surveyed. According to data of the National Social Insurance Institute, social security collections as of the end of September accounted for 79% of the 2007 budget projections. The total effect of the 1 percentage point decrease in the *Retirement Fund* contributions and 2 percentage point decline in the contributions to the *Unemployment Fund* in early October was estimated at BGN 118.4 million by end of the year. Furthermore, end-of-year revenues are expected to outperform projections by 4.3%.

The policy of a stepwise decrease in the social security burden, pursued in 2007, led to lower labour costs and higher disposable income. The altered employer/employee ratio (from 65/35 to 60/40) of contribution payment planned in 2008 will make up for the lower contribution from the point of view of employees. Nevertheless, the 2006 alleviation of the burden of 6 points has indicated that a positive effect overall for the economy along the lines of stronger employment and higher wages is very likely to take place. Also, the decreased burden is to promote investment and labour demand on the part of employers. At the same time, it should be noted that the effect of the latest tax amendments may not be as strong as the effect of the 2006 ease. On the one hand, the latest reduction ran lower than the preceding decrease. On the other, the effect of the amendments on the other indicators may not be measured as a linear relationship but a declining rather constant change of the latter.

One of the most significant amendments in 2008 refers to personal income taxation. The progressive income tax will be replaced by a 10% flat rate applied to all income groups, thereby removing the non-taxable income threshold requirement and entitlement to child tax credit. AEAF estimates show that the amendment will have a negative impact on the *up to BGN 450* income bracket alone. The expected effect will result in increased disposable income for the higher-income groups. Theoretically speaking, as the marginal propensity to save steps up with the higher income groups, tax flattening is expected to foster savings growth in the economy rather than consumption. This effect is to be further enhanced by the continuous burden shift from direct to indirect taxes, as the latter have a comparatively stronger regressive character. The above shift will be sustained in 2008 as well by raising the excise duty rates on fuels and tobaccos.

Total consolidated budget expenditures rose by 12.7% since the start of the year as a result of the country's contribution to the EU budget worth BGN 407 million as of the end of September. In addition, capital outlays posted a most robust increase of 32.5% having to do with the country's need for transport infrastructure renovation. They are expected to be the most vigorously performing public expenditure item in the last quarter also. The bulk of growth was triggered by the local government public investment made, as influenced by the very political cycle the country was and is still experiencing. Municipal public investment in the nine months to October ran well over the year's projections, with the major source of investment financing being the revenues amounts from the sale of non-financial assets.

As there was no record of sizable transfers, access to the EU structural funds has not yet promoted any significant government investment. The increased EU aid appropriations in 2007 were the result of the BGN 120 million worth of grants negotiated with the EC to support public finance providing for Bulgaria's accession.

Current expenditures lived up to expectations, advancing by 6.6% in the three quarters to October. Wage bill costs stepped up by 12.4% due to the annual update in government-sector wages. Budget spending on social scheme payments reported a 6.7% rise, with expenditures on in-hospital health care and pension benefit schemes enjoying the largest contribution to this growth. The nine months to October witnessed a certain drop in the number of both pensioners and pension benefits paid up of 1.4 and 1% respectively. Nevertheless, benefit payments went up by 5.4%, as prompted by the year-on-year pension increment.

Fiscal discipline in the third quarter eased off significantly. The Ministry of Finance authorized the extension of the 10% set-aside from current non-interest expenditures, although the 2007 current account deficit was expected to further worsen on a 12-month basis. At the same time, the budget surplus is to post a strong decline to about 3.1-4% of GDP under the impact of the public finance increase planned as of the year's end. In addition, the 3 percentage point decrease in social security contributions of early October will bring about a certain slowdown in Q4 revenue growth.

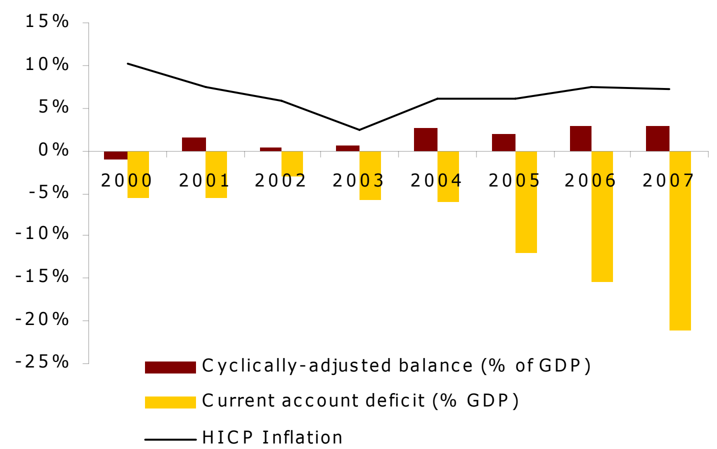
4.2 – Fiscal position

It is difficult to assess the government budget policies of the past couple of years unambiguously, as they have contained some elements of expansionism having to do with the ever-decreasing direct tax burden, which provided the stimulus the economy needed. On the other hand, the sizable budget surpluses in 2006 and 2007 may be viewed as imposing a certain constraint on the country's economic development. Therefore, the fiscal position should be considered primarily in the light of the key budget policy goals, which as laid down in Bulgaria's 2007-2010 Convergence Programme are as follows: maintaining the country's macroeconomic stability and catching up with EU living standards.

These two policy goals may be potentially contradictory. Catching up with EU living standards means fostering growth in the economy by means of fiscal measures, which other things being considered, may jeopardize the country's macroeconomic stability. It follows that the policy goals should be carefully and adequately prioritized, with macroeconomic stability being given the greatest importance. This a necessary condition for ensuring sustainable long-term growth, whereas fiscal stimuli may have a rather short-lived effect as they boost the economy only in a short-term perspective.

The current fiscal position has largely contributed to the country's macroeconomic stability. However, a major imbalance in the economy in the last few years had to do with the ever deteriorating current account deficit as well as inflation acceleration. Therefore, the fiscal policy response, in 2007 including, can be said to have been adequate to the economic conditions since the fiscal stimuli in the economy were lowered and budget savings went on the increase. Generally speaking, fiscal policies should be brought into line with the business cycle an economy is experiencing to keep up stability rather than bolster short-term unsteady growth.

FISCAL POLICY AND IMBALANCES IN THE ECONOMY

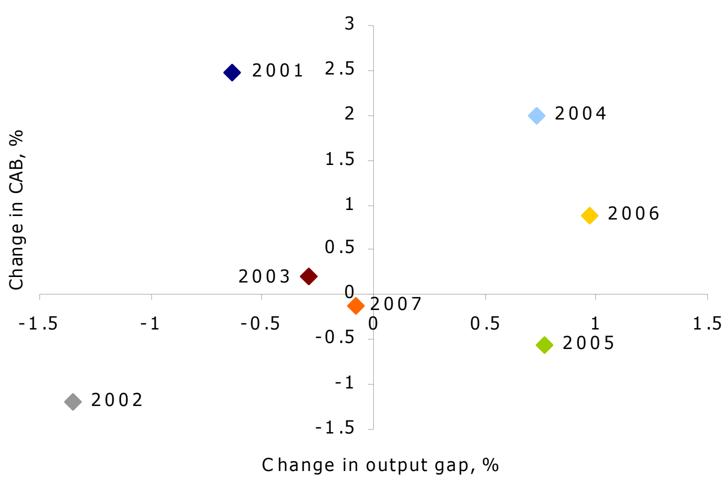


Source: AEAF, MoF, BNB

The assessment of the fiscal position as related to the business cycle draws upon the cyclically-adjusted budget balance, which gives a clearer picture of the discretionary fiscal policies. According to AEAF estimates, the Bulgarian economy was overheating throughout 2006, and 2007 as well. Accordingly, a decrease in the budget surplus down to some 0.8% of GDP, as laid down in the 2007 Government Budget Act, will pursue a pro-cyclical policy and mismatch grossly the key goal of keeping up the country's macroeconomic stability. On the other hand, forecasts suggest that the output gap in the next three years will narrow down to zero, allowing for a stepwise decrease in the budget surplus. The budget surplus has to be lowered in a gradual manner, taking into account the uncertainty of forecasts and cyclically-adjusted budget balance estimates. At the same time, it should be carefully considered against the hard budget constrains in order to minimize risks for public finance in the long run.

Long-term budget sustainability is also defined from the point of view of the hard budget constraint. The underlying assumption is that the discounted flows of the primary surpluses in an indefinite period of time will be large enough to meet the current government debt. However, hard

CYCLICAL FISCAL POSITION



Source: AEAF, MoF

constraint compliance is heavily dependent on the budget balance in the next few years. Therefore, given the same fiscal policies in the future, population ageing and its effect on public finance are likely to pose a serious risk for the budget.

According to the long-term demographic model of AEAF and NSII forecasts, the country's population is expected to post a strong decline by 2050. Its structure is to undergo significant changes, with the share of the *over 65 years of age* population rising drastically. As a result, the budget will have to shoulder the weight of ever-growing expenses on health care and pension benefits. At the same time, as the number of school age children is to go on the decrease, budget spending on education will contract. On the whole, however, the above effects are expected to offset each other. Furthermore, NIIS estimates as to the dynamics of expenditures on pension benefits as a percentage of GDP in 2050 do not indicate any notable change from their current levels.

In the aggregate the net effect of aging on public finance will have been close to zero by 2050. Practically speaking, it implies that the current fiscal position fully satisfies the budget constraint. What is more, the budget balance in the future can be reduced by about 4.8 percentage points of GDP on a yearly basis without jeopardizing fiscal policy sustainability. This assumption is further supported by the sustainability indicator used by EC to gauge the difference between the country's real fiscal position and the position satisfying the budget restraint in the years to come.

It follows that long-term public finance sustainability allows for some decrease in the current budget surplus without putting at risk the country's macroeconomic stability. However, this needs further clarification, viz. with a view to the unfavourable demographic developments after 2050, considering a period long enough in the future to estimate may significantly strengthen the effect of aging on the budget. Therefore, maintaining long-term macroeconomic stability means tightening the current budget to make room for any future effect.

In conclusion, keeping up macroeconomic stability via fiscal policies means complying with the long-term budget constraint in order to maintain public finance sustainability and avoid pro-cyclical fiscal stimuli. The current budget balance satisfies largely the above conditions while even making room for some policy ease up aimed at boosting the economy and catching up with the standard of living in the EU. Therefore, the fiscal position in the past two years – tax incentives for the private sector and comparatively strong budget surplus can be said to have been an adequate policy response to both the economic situation and the key policy goals it is after.

It should be also noted that any surplus reduction aimed at stimulating the economy should take place by way of measures enhancing the potential growth capacity to achieve a sustainable effect on the country's development. On the revenue side, the current tax system can be so amended as to improve the business environment and attract sizable investment. The lowered tax burden has proved to be the most viable instrument as high labour costs were identified as a major impediment to businesses. On the expenditure side, budget spending needs to be further streamlined and priority given to investment and expenditures having to do with high-tech production, technological upgrading and human capital development.

4.3 – Quality of public finance

Any increase in public spending will fail to produce an automatic effect on potential growth without ensuring the efficiency of budget expenditures. It is therefore important to make a clear-cut distinction between effectiveness and efficiency of spending. Effectiveness gives account of the relationship between input and output whereas efficiency shows the link between input and the attainment of strategic objectives. However, measuring both effectiveness and efficiency in practical terms is a difficult task to perform as there are no comparable statistical data whatsoever. At the same time, gauging input and output faces a number of methodological problems.

A standard indicator of school effectiveness draws upon the *student/teacher* ratio in a system. According to Eurostat data, the indicator in Bulgaria amounted to 13.2 in 2005, varying within the 13.2 - 13.7 bounds over the 2000 – 2005 period. A direct comparison in an international aspect shows that education in Bulgaria is effective by the same standard, with the above ratio in ten EU member states running a lot lower than in Bulgaria. However, the assessment of educational output, i.e. the level of education Bulgarian students obtain vis-à-vis other countries, is more informative. The results of 2003 TIMMS (mathematics), conducted by the International Association for the Evaluation of Educational Achievement (IEA), placed Bulgaria ninth out of the 11 EU member states, taking part in the studies. Again, as for the sciences, the country ranked ninth. On the other hand, adjusting the number of teaching hours, Bulgaria ranked second in mathematics and sixth in sciences. Moreover, the above achievements have been made relying on the least possible expenditure amounts on education in the EU, as measured per student in EUR by purchasing power parity. It follows that budget spending on education has been rather effective. Yet, the problem is that spending effectiveness posted a dramatic decline, as the performance indicator deteriorated significantly in the 2003 IEA survey as compared to the earlier findings of 1999 and 2003, despite the ever-growing allowance per student.

Public spending on health care per capita, as measured in USD by purchasing power parity, were steadily increasing in the 1999 – 2004 period[18], but had remained the lowest compared to EU member states but Roumania. Furthermore, as a percentage of GDP, public expenditures ran one of the lowest in EU at 4.1% on average in the same period. At the same time, the number of hospitals and hospital beds per 100 000 people was rather high, indicating a good level of development of the country's health care system. The indicators of population coverage as a share of vaccinated children, per cent of TB cases detected, share of in-hospital child births were also relatively positive. However, from the point of view of spending efficiency, things are not looking good for Bulgaria because the country is lagging significantly behind as regards some general health indicators. For example, the country ranks one of the first among EU member states in terms of child death rate and cases of tuberculosis and hepatitis *B*. Life expectancy at birth was 72.6 years in 2004 or one of the lowest in the Community.

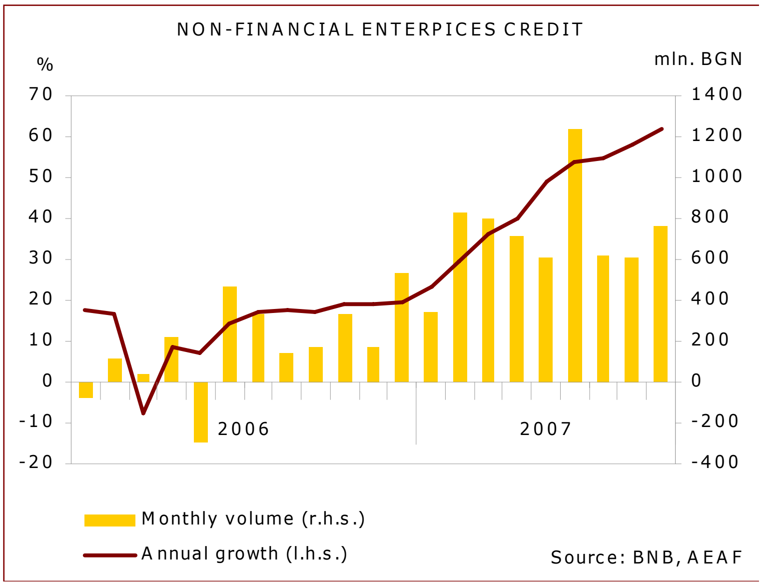
In conclusion, it can be assumed that public spending efficiency in education seems to be comparatively high, following a distinct downward trend in the past few years, though. As for health care, public expenditures have ensured a good level of population coverage, but their efficiency remains rather low. However, these conclusions need to be interpreted with great care as the indicators in the two sectors are by no means exhaustive. Besides, it should be also taken into account that the link between input and the results obtained is also susceptible to lifestyle and environment-related factors that need to be carefully considered in evaluating public spending efficiency.

5. Financial system

5.1 – Commercial bank lending

Early 2007 saw the removal of most administrative measures that BNB had imposed on bank lending in 2005 and 2006. Commercial banks geared up to the new environment very quickly and posted stronger loan volumes and growth. As of September, 12-month growth in claims on the non-government sector stepped up as high as 56.1%. Both loans to non-financial enterprises and household consumer and mortgage loans

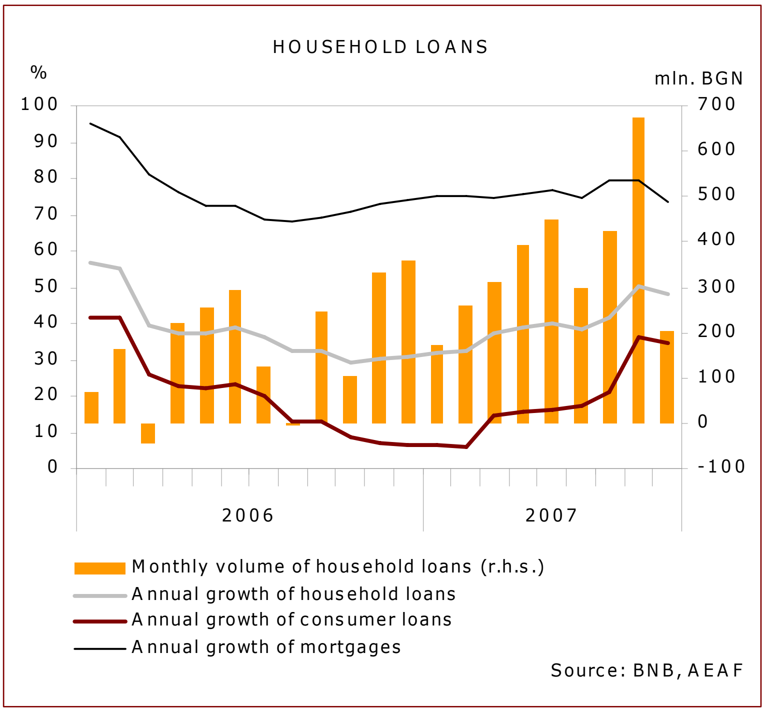
18. Data released by the WHO Regional Office for Europe.



went on the increase, rising by BGN 539 million on average in the nine months to October vs. BGN 178 million on a year earlier.

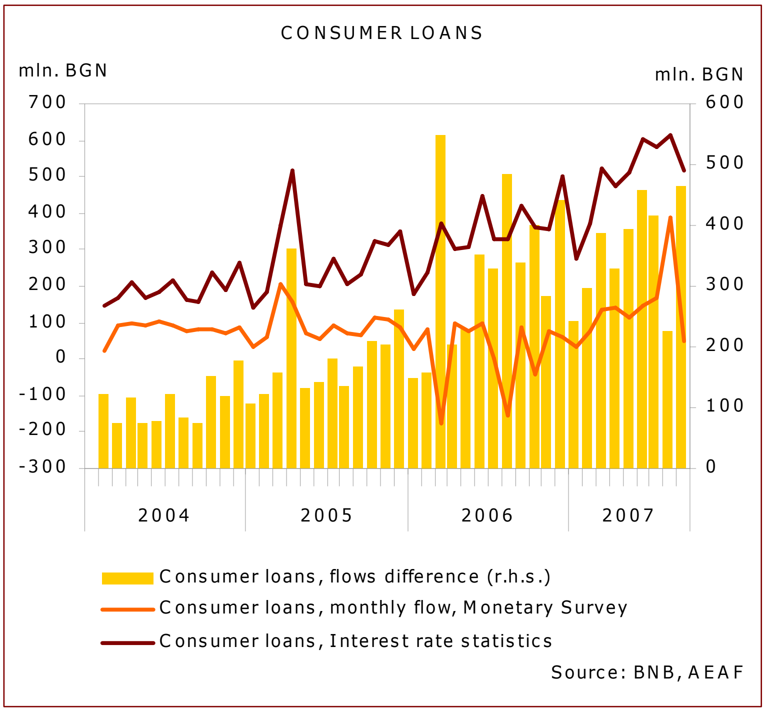
Credit to non-financial institutions reported the highest increase (61.9% on an annual basis in September). According to bank sectoral statistics, the loan resources borrowed were mostly channelled to retail trade, repair and car service, the processing industries and construction. These were also the sectors reporting the most robust investment activity.

The faster credit growth, especially in the second half of 2007, requires that an answer is given to the question whether 2007 credit growth was due to new loan extensions to the private sector or whether it was the outcome of buy-backs of loans that most commercial banks had sold abroad in the preceding two years. Estimations prove to be difficult as the officially published data do not allow for precision of calculation. A possible approach is to compare the month-on-month change in loans to non-financial enterprises and households, as taken from bank analytical reporting, and the flows of new loans under the interest rate statistics and formulate some dependencies that show that 2007 credit growth was by and large triggered by loan buyback on the part of banks. Loan change according to bank analytical reporting reflects the aggregate effect of the new credit extensions in a given month, repayments on principal on earlier liabilities and the result of a likely net sale of credit, whereas interest rate statistics give account only of the loans negotiated in a given month. It follows that the difference between the two flows will only provide a rough assessment of the effect of payments on principal and a likely net sale of credit.

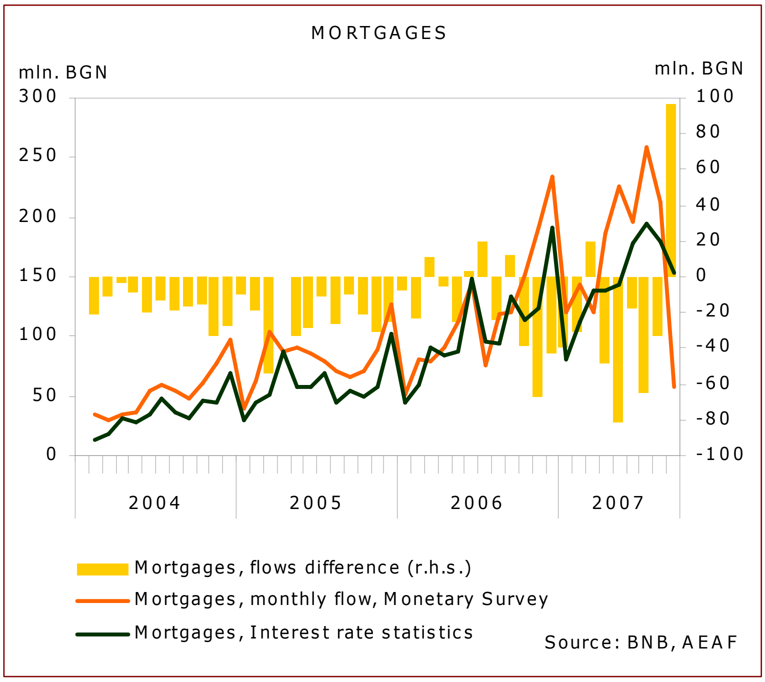


The comparison of the two flows by type of loan shows that new loans represent as a rule a larger amount than loan change according bank analytical reporting of consumer and corporate credit. The widening difference between the flows can be partly attributed to the interest-principal allocation in each installment. Considering the fact that most loans borrowed are repaid in annuities, we can say that in the first months of the repayment schedule the installment comprises a larger amount on interest and a smaller amount on principal or the difference between the two flows tends to widen naturally over time. Furthermore, it can be assumed that in some months when the difference gets off from its normal trend sharply, net loan sales enjoy a relatively heavy weight in credit growth. With consumer loans, the strongest differences manifested themselves in early 2006 as a result of the mass sale of consumer credit and then later in August 2007 (due to the likely buyback of credit having to do with the stepwise removal of the credit growth ceilings). The difference with corporate loans is a lot more volatile, with the strongest fluctuations being posted in July to August 2006 due again to credit sales and then in early 2007 when some portion of the loans were re-integrated in bank portfolios. As for housing loans, no such difference has been discerned due to the longer-term maturity term and no accumulation of payments on principal on housing loans extended in previous periods.

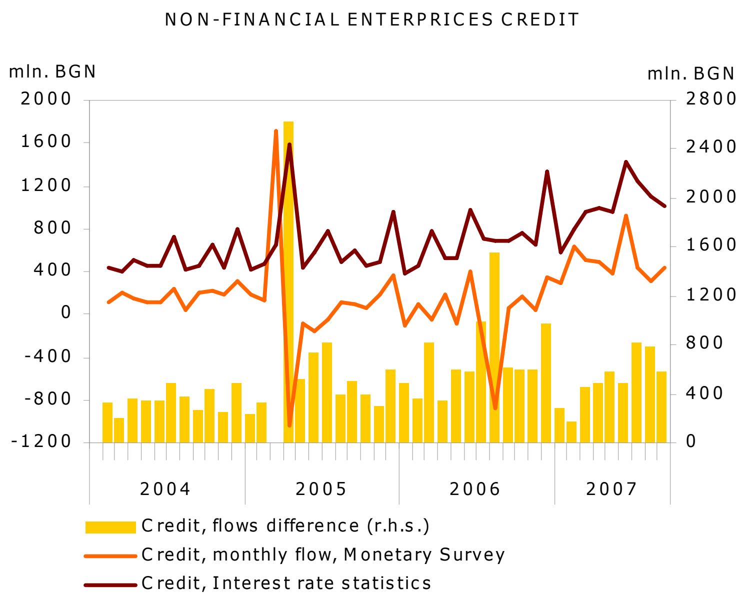
The credit expansion of 2005 was by and large financed by foreign resources. Unlike then, 2007 credit growth was mostly covered by the higher resident deposits at local banks. In the eight months to September, monetary aggregate M3 stepped up most vigorously by 19.2% or BGN 6.172 billion (vs. BGN 4.352 billion on a year earlier). Twelve-month growth in broad money amounted to 29.1% as of September, with monetary aggregate M1 and quasi money rising by 30 and 28.5% respectively.



The accelerated broad money growth was mostly underpinned by the higher deposits of agreed maturity of up to 2 years (19.6% up) and record high nine-month increase in overnight deposits of 24.3%. As expected, household deposits of agreed maturity, which also contain some saving elements, reported the strongest increase. On the other hand, the overnight deposits of non-financial enterprises stepped up significantly by BGN 1.536 billion over the same period. The dynamics of the different deposit types highlighted some distinct trends that were taken as early as 2006. On the one hand, the share of overnight deposits advanced significantly mainly at the expense of cash in hand. On the other, long-term deposits retained their share, favouring the banking system as a whole with a view to the increasing bank credit portfolios.

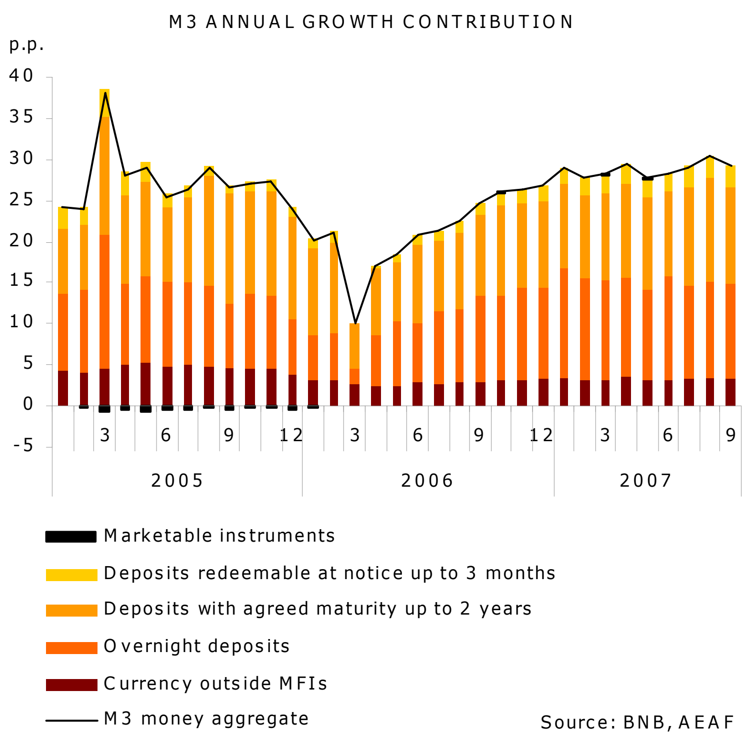


Net foreign assets have been more volatile due to the impact of the Central Bank's measures of the past couple of years, with 2007 witnessing again some significant change in their structure. The curb on lending over the 2005-2006 period led to an increase in bank deposits abroad and a concurrent drop in non-resident deposits at local banks, entailing a rise in net foreign assets. However, with the removal of the credit growth ceilings in 2007, commercial banks resorted to their deposits abroad to provide for lending in the country while continuing to be a deposit taker of foreign resources. As result, the net external position took a steady downturn, in September in particular, when in order to meet the new minimum reserve requirements and keep up lending, commercial banks withdrew large amounts of their foreign deposits and took new non-resident deposits. Consequently, net foreign assets plunged to – BGN 3.021 billion from –BGN 617 million in August inside a month.



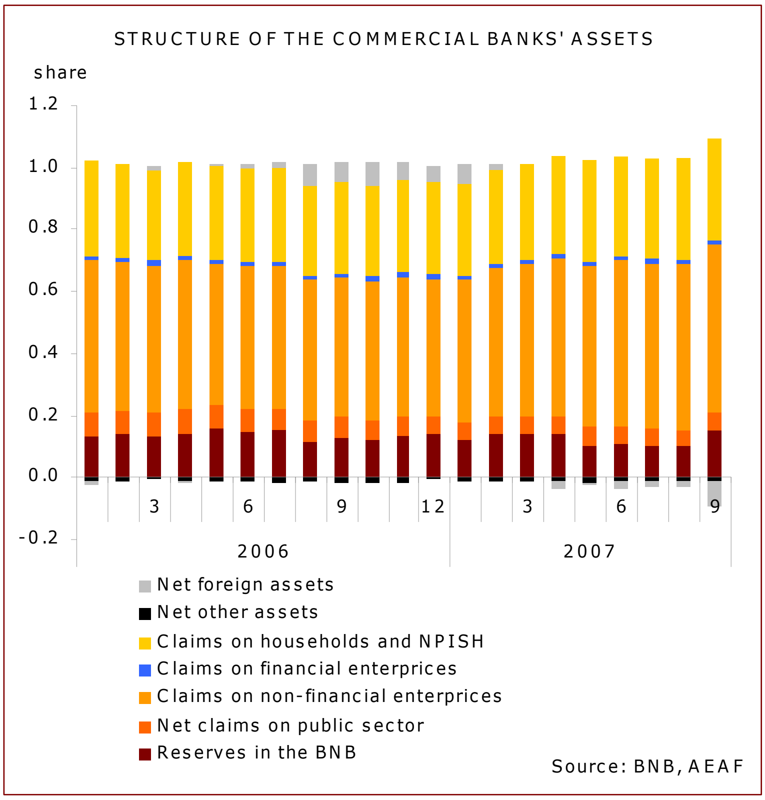
Source: BNB, AEAF

Although credit expansion in the economy was not coupled with deterioration in the bank credit portfolio quality (the share of bad debts and loan work-outs remained almost unchanged relative to the end of 2006), the Central Bank decided to reduce liquidity by raising the minimum required reserves from 8 to 12%, effective from 1st September. The reasons for the above increase had to do with concerns over serious credit risk in the system and fears that lending standards may be undermined as a result of competitive pressure. The above fears were well-grounded since private-sector foreign debt had posted a rather strong rise, the current account deficit showed no signs of improvement, and FDI structure pointed to no investment in viable businesses of high productivity to underpin sustainable long-term growth. The problems stated are as a rule addressed by way of monetary policy measures rather than by raising the minimum required reserves. A likely solution is to shift the focus on banking supervision and amend the regulations providing for risk exposures and capital adequacy, or introduce measures tying up the amounts of loans extended to a borrower with the income stated. The currency board arrangement currently in operation allows for the above policy decisions.



Source: BNB, AEAF

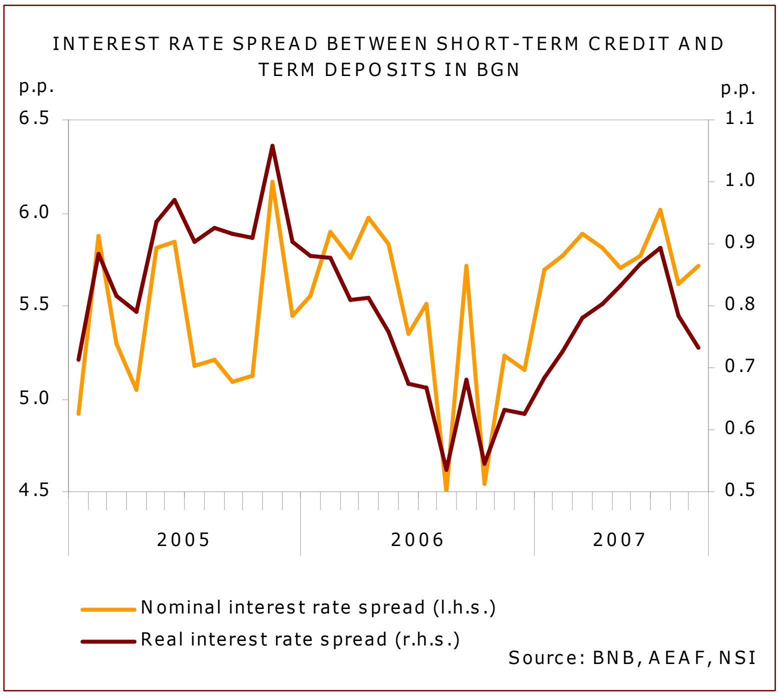
The expectations of the Central Bank as to the impact of the higher minimum reserve requirements indicate a certain decline in the disposable resources of commercial banks, hence higher interest rates, putting many borrowers off, in turn. All this could hold true if local banks did not enjoy easy access to financial resources to cater for their lending activity. Furthermore, they can rely on large amounts of foreign resources to provide for lending, thereby bypassing any domestic restrictions. Whether the new measures will lead to higher interest rates in the economy or not is debatable for two reasons. On the one hand, 2007 sustained the upward interest trend in the global markets, which will sooner or later have its effect on the local financial system. The market turmoil of last August, having to do with misjudged investment decisions, and follow-up liquidity crisis exerted an additional upward pressure on interest rates while making players even more cautious. On the other, inflation has been steadily rising since mid-2007, pushing the already low real interest rates further down. It follows that commercial banks may raise nominal interest at their discretion in attempt to take more deposits while ensuring a positive return on the loans extended. The above two factors, viz. the rise in global interest rates and inflationary pressures in the local economy happened to take place at the time or shortly after the Central Bank had announced stricter minimum reserve requirements, producing an extra curbing effect on lending. And last but not least, it is noteworthy that any change in the minimum required reserves in general is an instrument that manifests itself with a great lag in time and is, therefore, exploited when longer-term liquidity objectives are sought after. That is why, credit growth is expected to slow down and interest rates to rise over time.

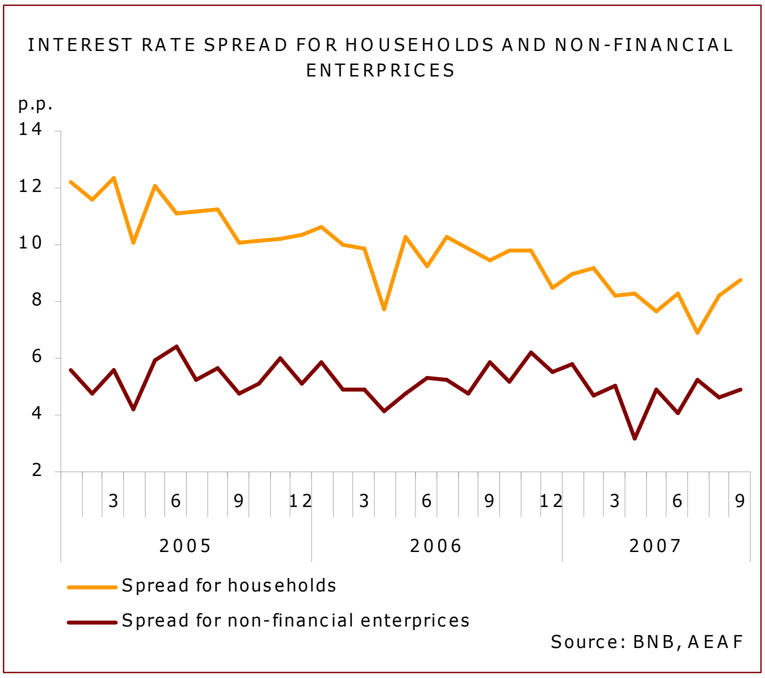


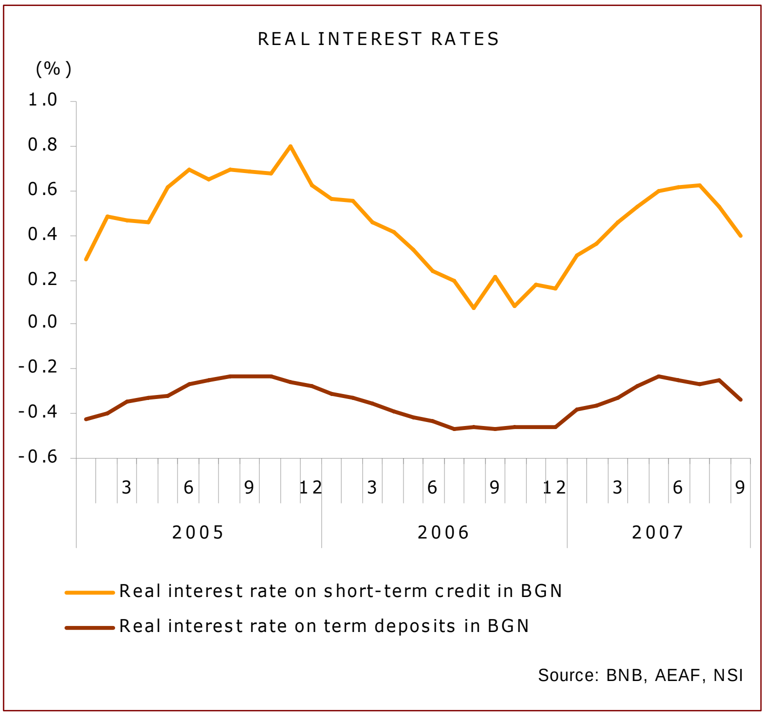
5.2 – Interest rate dynamics

The 2007 increase in interest rates in the global markets as a response to the measures taken by leading banks affected local interest rates, inducing a year-round rise first in the interbank market and then in private-sector deposit and loan interest at a later point.

The increase in the interbank market interest rates did not prove crucial to the volumes traded. The overnight SOFIBID and SOFIBOR were steadily advancing to 4.09 and 4.32% as of October, posting a nine-month rise of 67 and 81 b.p. respectively. In the last months of the year the spread between the indices widened. The interbank market dynamics was indicative of insufficient liquidity in the banking system (especially after August when the global financial markets were experiencing a severe cri-







sis), hence a higher cost of resources. Yet, it should be noted that the country's financial system commands enough reserves to ensure liquidity have banks been facing systematic difficulty. On the one hand, the deposit of the Banking Department was steadily stepping up to BGN 2.219 billion as of the end of October. On the other hand, some portion of the BGN 8 billion worth of government deposit with BNB may be put at commercial banks, if need be. And last but not least, BNB may at any time amend the minimum reserve requirements, opting for a decrease this time.

The upturn in the interest rate spread between short-term loans and time deposits in BGN was noticeable as early as the end of 2005 and beginning of 2007, holding steady at about 5.8 percentage points (5.7 p.p. as of September).

The amended methodology of interest rate reporting of early 2007 has made the analysis of interest rate dynamics and loan and deposit volumes rather difficult because interest rate statistics now gave account of the new loan and deposit contracts alone, disregarding automatic renegotiations and thus influencing the volume records.

Deposit interest was smoothly rising throughout the year. As of September, time deposit interest went up as high as 4.18% vs. 3.47% in December'06. Overall, the interest rates on loans of different maturity term and currency followed a distinct upward trend, too.

The higher summer inflation exerted an extra pressure on the already low return on bank deposits. Besides, as competition in the sector grew stiffer, loan interest did not step up high enough to make up for the higher price inflation in the country and the cost of credit remained relatively low.

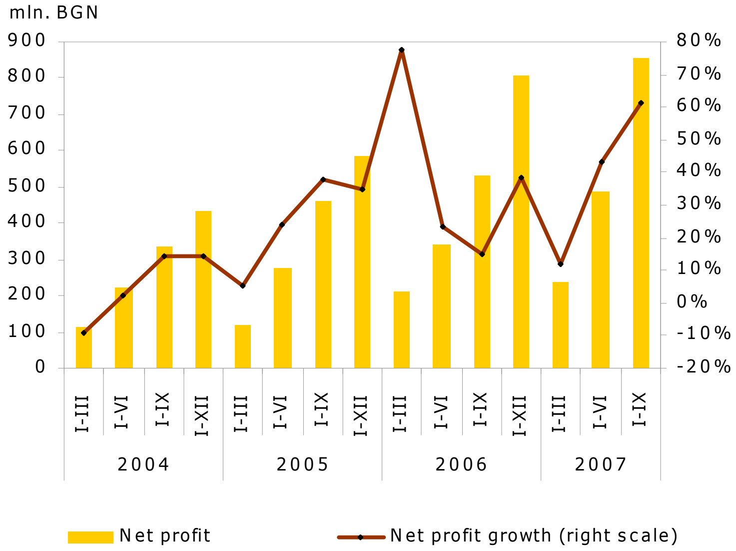
5.3 – Banking system

The banking system was performing vigorously in a predictable macroeconomic environment ensured by the currency board arrangement and prudent fiscal policies. On the demand side, income growth and higher employment in the economy were the main factors at work behind the sector's expansion and deepening financial intermediation.

As of the end of September, assets in the banking system posted a 34% increase to BGN 51.9 billion vs. 28.4% on a year earlier. The faster growth was triggered by the complete removal of BNB restrictions in February[19], giving bank lending a stronger push. Growth in assets was also underpinned by private-sector credit growth, as well as cash and cash balances with the central bank. As of September, the latter went up by BGN 2.17 billion on a 12-month basis, with the bulk of this increase being reported in the same month. The above development had to do with the higher minimum required reserves (as of early September.), as entailed by another series of BNB restrictions aimed at curbing credit growth in the economy and retaining the stability of the banking system.

Net profit in the system went on the increase as lending gained further momentum in 2007. Net profit in the nine months to October posted a vigorous year-on-year rise of 61.5% (or BGN 325.6 million), hitting BGN 855 million. The bulk of the profit (67.3%) was due to the five biggest banks[20] as regards the accumulation of balance-sheet assets whereas all remaining banks (foreign bank branches excluded) accounted for some 30% of the period's net profit. The increased net interest income, which stepped up as a result of the greater absolute-term change in interest revenues, having to do with the larger amounts of loan extensions, made a major contribution to net profit growth.

NET PROFIT OF THE BANKING SYSTEM



Source: BNB, AEAF

Bank consolidation in 2007 led to greater bank asset concentration. As of the end of September the four largest banks held 48.8% of total assets in the banking system (vs. 43.6% on a year earlier) due mostly to the Q2 merger of Bulbank, HVB Bank Biochim and Hebros Bank. Bank consolidation has been, among other things, underpinned by: first, the country's accession to EU and mutually recognized licences granted by the member states' central banks have only made competition in the sector stronger. Second, in order not to yield to competitive pressure on the part of foreign players, local banks have been attempting to gain a bigger market share by either a more aggressive market behaviour or by mergers. As a result, the number of credit institutions licensed elsewhere in EU with notification to carry out activity on a cross-border basis in Bulgaria numbered 71 as of October.

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19. The BNB has embarked on a stepwise alleviation of the 2004 and 2005 administrative measures on commercial bank lending. First, in August 2006 the central bank authorities removed the progressive scale of the minimum required reserves commercial banks had to maintain, had their credit portfolios stepped up at a pace higher than the rate laid down in Regulation #21. Second, in December'06 BNB made some amendments to Regulation #9 on the evaluation and classification of bank risk exposures and provisions, having to do with household mortgage and consumer loans. The amendment provided for equal- rate provisioning as corporate customers. In addition, BNB removed the six-month period of retention in cases of renewed debt servicing on consumer and mortgage loans classified as irregular, non-performing or under surveillance. Furthermore, February'07 witnessed the complete removal of the additional minimum require reserves requirement.

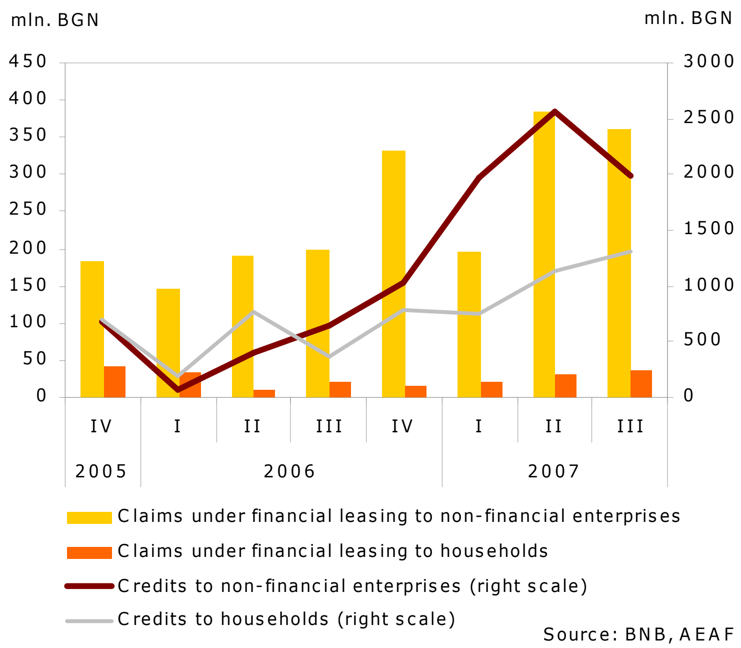
20. According to the new classification of bank groups, the five largest banks make up group 1. Group 2 comprises all remaining banks but foreign bank branches, as the latter form a third group of their own.

However, commercial banks had to face even stiffer competition on the part of other non-banking financial intermediaries such as leasing companies, collective investment schemes, etc., offering a viable alternative to bank products. Their advance is often best seen in times of strict lending restrictions, which only provide a strong stimulus for the swift development of non-banking financial institutions. As a rule, lending restrictions do not have a curbing effect on the demand for financial services and products of economic agents because demand depends on income and employment, which are not sensitive to central bank restrictions.

5.4 – Non-banking financial institutions

2007 was marked by the swift advance of the leasing industry, as spurred by the growing demand of economic agents for financial resources to cater for their operations. Assets posted a most robust rise of 88.1% up to BGN 3.85 billion as of end of September (vs. 81.6% on a year earlier). The year-on-year growth was triggered mostly by the loan extensions, which accounted for 78% of the asset total in the industry in the same reporting period.

CHANGE OF BANKS' CREDITS AND FINANCIAL LEASING OF HOUSEHOLDS AND NON-FINANCIAL ENTERPRISES



Source: BNB, AEAF

The structure of claims on financial leasing by institutional sector indicated that most leasing companies targeted at non-financial enterprises and some other economic agents in a lesser degree. Claims on non-financial enterprises stepped up by 93% on an annual basis to BGN 2.6 billion as of the end of September (vs. 110% on a year earlier). The bulk of financial leasing to non-financial enterprises was channelled to the processing industries, construction and retail trade, car and motorcycle repair and service, personal belongings and home appliances. At the same time, despite the high intra-company indebtedness, the allocation of leasing resources to the processing industries and retail trade was a positive development as most companies used them to augment investment in productivity improvement, expansion and income generation in the economy. The above tendency towards accumulation in the aforementioned sectors of loan resources originating from the leasing industry was also evident from data on bank loans extended to enterprises.

As of the end of September, claims on households stepped up at a modest pace by 46.5% on a 12-month basis, or BGN 335.1 million (vs. 88.5% on a year earlier). Compared to bank consumer and housing credit to households, the share of change in household financial liabilities to leasing companies in total net liabilities of households ran comparatively low (2.6% in the third quarter of 2007 vs. 5.3% on a year earlier). A possible explanation of the modest share was that bank lending gained further momentum with the removal of BNB restrictions. However, the new administrative restrictions of the Central Bank on lending are expected to trigger a switchover to alternative forms of financing such as leasing schemes.

The country's accession to EU in early 2007, sizable financial inflows and strong performance of the companies listed on the stock exchange were the factors at work behind the capital market upswing. The stock exchange indices SOFIX and BG40 posted a vigorous year-on-year growth, as underpinned by the higher share prices and active trading. As of the end of October, SOFIX surged by 76.1% on an annual basis whereas BG40 soared by a most robust 222.4%. The factors that bolstered trading, i.e. strong financial performance, blue chip issues and vigorous demand also pushed prices and indices up. September 3rd saw the introduction of two new stock exchange indices - BG TR30 and BG REIT. BG TR30 is a broad index, which differs from BG40 in that the companies in the index portfolio enjoy equal weights, and has been so designed as to give a clearer account of market fluctuations. On the other hand, BG REIT is estimated on the basis of the share performance of special-purpose investment companies (dealing with securitization of real estate and land), i.e. real estate investment trusts. BG TR30 started on a solid footing, reflecting the market run, and posted a 21.6% rise ever since its construction. At the same time, BG REIT reported a wobbly start, plunging well below its initial value of 100 points only to go on the rebound ever afterwards. Its unsteady performance was by and large fostered by the lack of any agitation in the real estate market on the supply side and low number of transactions actually contracted.

As of the end of October, the market capitalization of the Bulgarian Stock Exchange amounted to BGN 29.1 billion, going up most vigorously by 134% on a year earlier. The *market capitalization/GDP* ratio was up at 40% at the end of June from 31.2% at the end of 2006.

In January, stock exchange trading picked up at a rather brisk pace. The following three months, however, witnessed significant price corrections, with the demand for securities going on the decrease because most market players had adopted a "wait and see" attitude as regards the release of the financial statements of the listed companies and floating of new issues. Furthermore, the global stock market slump, as prompted by some price corrections on the Shanghai Stock Exchange, exerted an additional downward pressure on local share prices. However, trading rebounded in May when the financial statements released lived up to the expectations of investors. The floating of a series of blue chip issues gave a new push to trading, arousing strong interest at the IPO market where the orders placed ran well over the shares offered.

Depth of Financial Intermediation, % of GDP

	2001	2002	2003	2004	2005	2006	H12007
Commercial banks assets	41.1%	44.9%	50.0%	64.2%	76.8%	86.0%	90.9%
Market capitalisation of the stock exchange	3.7%	4.2%	7.9%	10.4%	19.7%	31.2%	40.0%
Insurance penetration	1.6%	1.9%	1.9%	2.1%	2.5%	2.6%	2.9%
Pension funds assets	-	-	1.5%	2.0%	2.6%	3.1%	3.6%
Collective investment schemes assets	-	-	-	0.1%	0.2%	0.6%	1.1%

Source: BSE, FSC, NSI, BNB, AEAF

The sharp fluctuations and considerable losses suffered by the world financial markets, as caused by the mortgage credit market collapse of last August, did not undermine the performance of the local capital market. On the contrary, investor optimism remained high and trading was following a brisk pace due to the availability of enough idle money waiting for better investment opportunities and blue chip issues, as well as due to the strong financial results posted by the listed companies. The capital market upswing was retained well until October when the absence of fundamental factors to keep up the levels recorded led to share price corrections favouring a downward movement or retention.

The swift advance of the collective investment schemes gave a powerful additional impetus to stock exchange trading. Household income growth and improved household financial culture as to the identification of forms of saving other than bank deposits had crucial importance. Household funds are invested in the capital market giving rise to a stronger demand for shares and pushing up share prices while ultimately bearing a higher return on investment. The majority of investment companies and contractual funds reported a very strong annual rate of return as of mid-2007. In addition, the investment portfolios of the collective investment schemes underwent significant alterations, viz. as of the end of June the weight of shares traded on the stock exchange stepped up to 46.4% from 34.3% on a year earlier. Furthermore, the share of foreign securities rose fourfold to 8.2%, indicating a deeper level of integration of the local market into the global markets. The gross assets of collective investment schemes posted a most robust year-on-year increase of 244%, and their share within GDP advanced to 1.1% as of the end of June.

Pension fund assets accumulated in the nine months to October amounted to BGN 2.2 billion, going up by 57.5% relative to September'06. Their share in GDP stepped up, too, from 3.1% in December'06 to 3.6% at the end of the second quarter of 2007. The liberalization of pension fund investment activity and removal of any privileged government access of these financial intermediaries provided for more viable investment opportunities in various financial instruments. The large amounts of resources accumulated by pension funds and necessity to investment them created additional demand for shares and bonds traded on the stock exchange, giving a strong forward push to both prices and the capital market.

Insurance penetration depth amounted to 2.9% of GDP in the first half-year period of 2007. Gross premium income ran at BGN 1 billion as of the end of September, rising by 20.4% on a year earlier.

6. Inflation

2007 inflation ran well over the levels reported in the past few years, hitting 11.4%, as measured by HCPI[21], on a year earlier. Unlike the preceding years, the country's inflation was by and large shaped by free market prices (of both goods and services) rather than any increase in administered prices.

The key factors at work behind 2007 market price change can be grouped together as follows:

- price change in the international markets, affecting local inflation dynamics. This includes change in the price of crude oil and fuels, basic agricultural goods and food items. They have a direct effect on HCPI and an indirect impact on producer prices in all the up- and downstream industries;
- Bulgaria's accession to EU and price and income convergence on the EU average.

Increased market price inflation was mostly due to food items the prices of which were most seriously affected by drought and global food and energy prices.[22] In November food price inflation hit 22.4% on an annual basis, picking up most vigorously in the summer months. This seasonal pattern of food price change was not typical as the summer months witness, as a rule, a decrease or an insignificant increase in prices.

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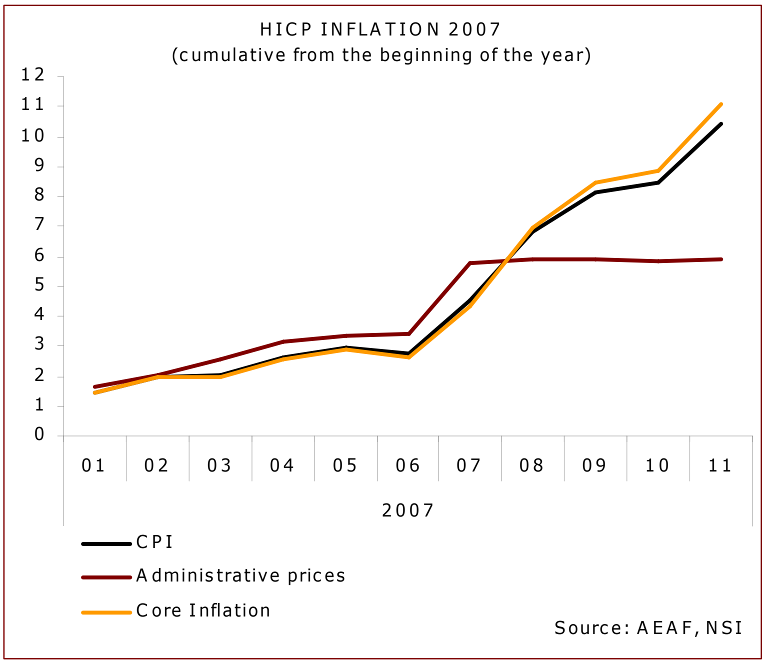
21. The harmonized CPI is estimated on the basis of a methodology elaborated by Eurostat. It is aimed at measuring inflation drawing upon CPI on a comparable basis, taking into account the differences in the national definitions. NSI has been evaluating and publishing HCPI data since the start of 2007, with the index series commencing from early 2005. However, the national CPI has not been harmonized only as regards expenditures made by non-residents. However, the two indices display strong differences due to the different structures of the weights.

22. According to WB data, the international prices of a number of main commodities (crude oil, gas, wheat and cereal, fats and oils) reached a historical high in 2007. The above comparison draws upon price change in the global markets, as calculated in EUR (BGN).

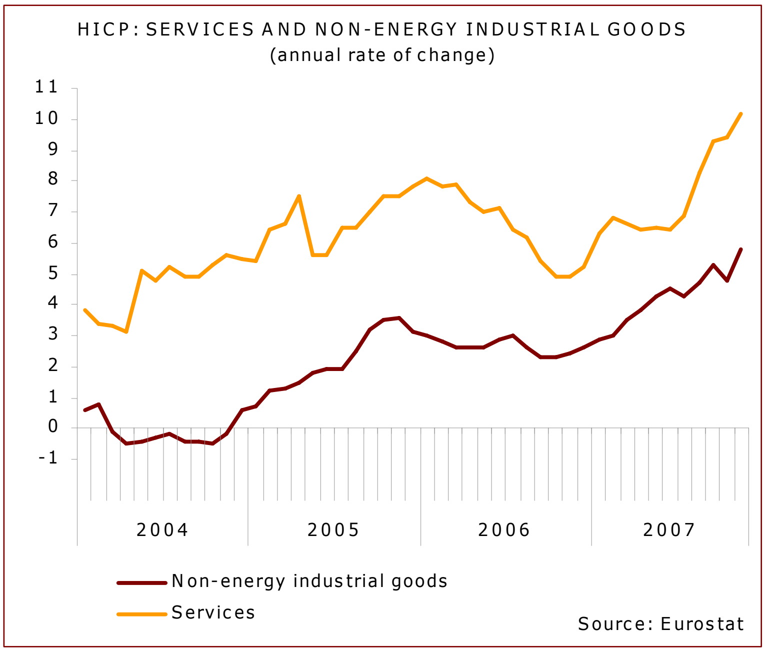
The robust pace of food price rise was largely set by the bad weather conditions and poor crop yields not only in Bulgaria but worldwide. The effect of the factor is gradually wearing out and food price dynamics in the next months is expected to set back very close to the seasonal patterns of change discerned in the preceding years.

On the other hand, the country's accession to EU, where the price level is significantly higher, may have produced a very strong effect on local food prices. According to data on inbound tourism, holiday makers from Greece and Rumania over the January-September period stepped up by 31.9 and 113.5% on a year earlier, ranking first in terms of visits to Bulgaria. Retail sales to foreign tourists pushed prices up in some border areas while prompting an overall price increase in the interior of the country as well. The above effect on inflation is to persist well into the next few years but is expected to gradually wear out, making a lower contribution to overall inflation, as compared to 2007.



Non-energy non-food prices were steadily going up throughout the year due to the stronger effective demand of households financed by both higher real income and eased access to bank lending. Increased home buys resulted in higher demand for home furniture and equipment items and exerted some pressure on prices. Although home prices are not part of the inflation index, the real rise[23] reported has affected consumption, hence overall inflation. The stronger purchases of homes and durables have entailed higher consumption in both a short and longer-term perspective along the lines of services having to do with the use of homes and durables.

Energy prices stepped up by 9.3% in the period surveyed due mostly to the higher global crude oil prices. The early-year price rise in liquid fuels ran lower than the increase expected as a result of the higher excise duty rates. The lower global oil prices in January explained the modest 2.6% rise on average in liquid fuels, given the increase in the excise duty rates on unleaded petrol and diesel of 20 and 24% respectively. The price rise in electricity for household and manufacturing purposes took effect in early July. Electricity for household pur-



23. *Real housing price rise takes account of the outstripping price increase compared to inflation. For instance, according to NSI data market housing prices over the January-September'07 period stepped up by 26.8% on a year earlier, whereas inflation advanced by a modest 6.3%.*

poses reported an average price rise of 7.8%, pushing the overall index by 0.35 percentage points. The other administratively priced items posted a 4.9% increase on average in the ten months to November, making an overall contribution to inflation of 0.8 percentage points in the same period.

On 1st July 2007 the energy market in Bulgaria was fully and officially liberalized. Nevertheless, the market situation has not changed drastically. Restructured as they are, NEC and Bulgargas are still state-run while continuing to hold a monopoly market position and questioning competition effectiveness. A major drawback is that there is no energy exchange in place. But whether the country needs it currently or not, is a question open to suggestions. It will limit the NEC's monopoly but manufacturers will have to pay a high price for their free choices. Electricity prices in Bulgaria are the lowest in the EU.

The factors that influence the price level in Bulgaria in the post-accession period have to do with the continuous convergence, excise duty rate alignment to the EU thresholds and implementation of the Common Agricultural Policy (CAP) and Common Customs Policy (CCP). CAP implementation is expected to push food prices up as it imposes stricter production requirements and manufacturing practices, with the impact on dairy products being the strongest. As for the sugar sector, prices are to go on the increase, too, because of the higher CAP-provided purchase prices and customs duties. At the same time, CCP has an anti-inflationary effect boosting intra-EU trade while indirectly promoting internal market competition.

Bulgaria is the EU member state reporting the lowest *per capita* income, hence the lowest price level[24]. The correlation between income, productivity and the price level is very strong. Over the 1997-2006 period, the *income to prices* ratio amounted to 0.9, whereas the *productivity to prices* ratio ran at 0.93. The outstripping growth in the country's productivity vis-à-vis EU average allows for a parallel income adjustment in Bulgaria, hence higher local price inflation in relation to EU average.

The Balassa-Samuelson effect, which also gives account of the price adjustment process, indicates that the latter has had a rather insignificant effect on the faster country's inflation, as compared to the other EU member states. A juxtaposition of productivity in the Bulgarian economy to the Euro area reveals that relative productivity in the manufacturing sector runs slightly up relative productivity in the sector of non-tradables – services minus the public sector. It therefore follows that income growth in Bulgaria vis-à-vis other EU member states has made a stronger contribution to the higher price level and inflation.

At the same time, the factors containing domestic price inflation had to do with government consumption and budgetary-sector wage formation. In addition, the decision of BNB of 1st September 2007 to raise the minimum required reserves of commercial banks is expected to put the brakes on credit and money supply growth, hence inflation. ▌

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24. According to 2006 Eurostat data, per capita GDP by PPS accounted for 37.1 per cent of EU 27=100, whereas productivity and the price level per employed amounted to 37.6 and 35.3 respectively.