THE BULGARIAN ECONOMY: ANALYSIS AND OUTLOOK

growth report

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

Autors: Albena Nikolova, Georgi Chukalev, Gergana Mihaylova, Dimitar Vasilev, Zornitsa Fikovska, Ivan Ivanov, Irena Christova, Lubomir Dimitrov, Milen Troskov, Nedyalka Dimitrova, Ognyan Gerdjikov, Plamena Petrova, Stefan Tsvetkov, Tsvetan Hadjiysky.

Translated by: Albena Toneva

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List of Abbreviations:

AEAF	Agency for Economic Analysis and Forecasting
GDP	Gross Domestic Product
GVA	Gross Value Added
BNB	Bulgarian National Bank
VAT	Value Added Tax
CPI	Consumer Price Index
IMF	International Monetary Fund
MF	Ministry of Finance
LFS	Labour Force Survey
NSI	National Statistical Institute
OPEC	Organization of the Petroleum Exporting Countries
FDI	Foreign Direct Investment
WB	The World Bank

Macroeconomic Highlights

The third quarter sustained the robust performance of the Bulgarian economy and GDP growth amounted to 5.8%. Over the July-September period, the country's employment stepped up by 91.5 thousand, going 3.1% up on a year earlier. The unemployment rate has held steady at around 11% for a third quarter in a row, running not only well below preliminary estimates (11.3%)[1], but also hitting a record low ever since the NSI started conducting labour force surveys. Due to the improved balances on services and current transfers, the current account surplus ran twice as high as expectations. 2004 inflation amounted to 3.98%. In addition, the currency board arrangement remained stable, reinforcing the country's macroeconomic stability. The cash surplus of the general government budget reached a record high of BGN 1.5 billion as of end-November, accounting for 3.9% of the 2004 GDP forecasts.

Demand Factors

Third-quarter GDP amounted to BGN 10.8 billion (at current prices). A major factor of growth had to do with the increasing foreign demand for Bulgarian goods and services. Over the same period, exports stepped up by 15.5%, making a 9 percentage point contribution to GDP growth. Furthermore, the outstripping growth in exports vis-à-vis imports ensured the positive contribution of the external sector to GDP growth. The high holiday season and the growth-conducive market situation worldwide, as manifested by the high metal prices, were the main factors at work behind the above developments. Infrastructure and capacity in both the Black Sea and winter resorts improved tremendously. It is also important that the number of holiday makers, visiting Bulgaria has gone on the increase. And yet, the fact remains that the country is still an attractive holiday destination for not so well-to-do tourists mostly. On a year earlier, 2004 growth in revenue from tourism is expected to exceed 20%. The high holiday season also fostered higher than expected export receipts from services in the balance of payments. The inflows of current transfers, the bulk of which being essentially private transfers made by compatriots working abroad, increased most vigorously. As a result of the improved balance on services and current transfers, the Q3 current account surplus ran twice as high as expected (MEUR 398 vs. MEUR 209 projected in the previous AEAF publication).

The stronger foreign demand and rising international prices of some main commodities favoured the country's export performance in 2004. Exports stepped up mostly as a result of the robust contribution of raw material exports (accounting for over 40% of the country's exports) due mainly to the high ferrous and non-ferrous metal prices worldwide. Investment goods, which as a rule have a high value added, reported a steady export growth rate. At the same time, having been a major engine of export

[1] See October'04 Short term forecast of the Bulgarian Economy, AEAF, (available upon request).

growth in the past couple of years, consumer goods, clothes and footwear in particular, now posted a weaker export increase triggered by the headlong depreciation of the USD to the EUR and hence the BGN, which in turn undermined the competitiveness of Bulgarian goods.

The foreign exchange peg of the BGN to the single European currency and deepening integration of the country into the EU internal market have predetermined Bulgaria's stronger export orientation to the EU. About 80% of Bulgarian exports are now destined to the EU (25) and the Balkan region and only 5% of them to the USA, 1% to Russia and 6% to Asia.

The stronger domestic demand boosted further Q3 GDP growth. More specifically, it was investments that performed most vigorously, though their share within GDP growth amounted to a bare percentage point. As expected, investment demand over the same period was somewhat curbed by the negative contribution of inventories to GDP growth.[2]

GDP Growth by Final Use Components

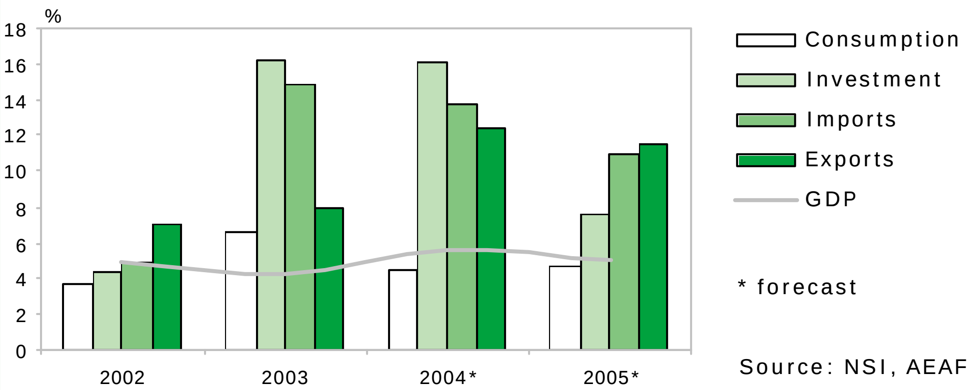


Chart 1

Balance of payments statistics also point to higher investments in 2004. The expectations are that FDI throughout the year will hit a new record high. However, the bulk of investments are financed by way of national savings. In the nine months to October, national savings accounted for 81% of total investment in the economy and reported a 45% year-on-year rise.

Q3 growth in consumption slowed down to 3.7%, running well below GDP growth and prompting a nearly 3 percentage point drop in its share within GDP down to 76%. This was largely due to the boosted investment activity in the country, which as already pointed out, is predominantly financed by way of national savings. The restructuring of consumption became all the more distinct in the third quarter when the share of non-food items increased, indicating a certain improvement in the standard of living. Another positive development had to do with the declining weight of output for own final use down to 7.15% (a 1.2 percentage points) of GDP, as measured by self-sufficiency and unincorporated enterprises, which accounted in part for the insignificant rise in the weight of food goods purchased. Weaker consumption also led to a certain slowdown in import growth and hence the positive contribution of the external sector to GDP growth.

[2] Ibid.

Supply Components

All sectors of the economy made a positive contribution to value added growth, with services in the lead with 5.9%. This was largely possible owing to the high profit margin in the banking sector and deepening financial intermediation - the finance industry stepped up by 17.8% and made a 0.5 percentage points contribution to GDP growth. The faster growth rate in the industry resulted in a higher share GDP. Trade followed suit posting a two-digit growth rate (11.9%), sustaining the early-year upward trend of performance. The high holiday season also made a positive contribution to GDP growth over the same period[3].

In the third quarter, the manufacturing industries reported a certain slowdown in value added growth (down to 5.1%), but remained the most vigorously performing sector of the economy, registering a 6.3% increase in gross value added on a nine-month basis. Growth in the sector was boosted by the interplay of the following factors at work: in the first place it was the higher foreign demand for basic metals, steel and copper in particular. *Metal production and casting* reported the strongest contribution to growth in sales, with over three-thirds of them being export sales. Throughout 2004 metal prices steadied at levels favourable for the Bulgarian producers. Furthermore, copper prices on the London Metal Exchange hit a record high in the fourth quarter, making the worldwide market situation all the healthier. The scrap price index of Eurofer has held steady at a five-year high, implying that the demand for ferrous metals is still robust. Another factor had to do with the strong performance of the construction sector and all related industries. In the third quarter, the sector posted a 10.5% gross output growth and a 7% rise in value added.

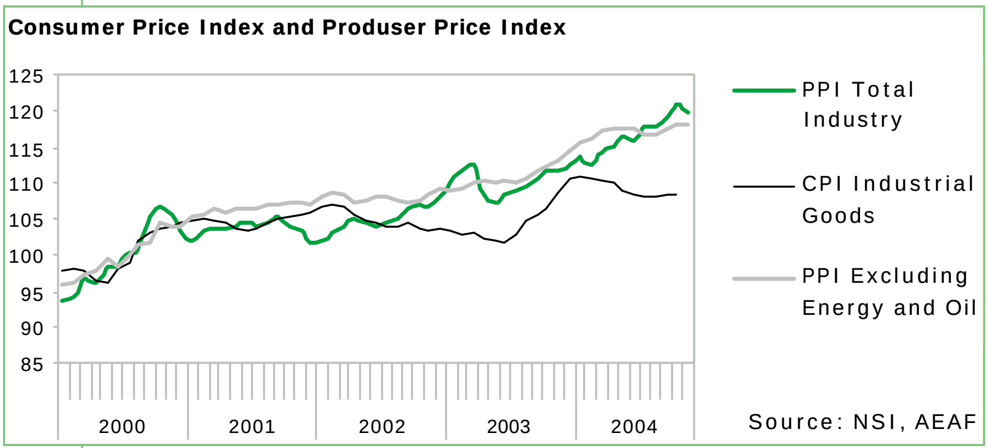


Chart 2

Notwithstanding the high growth in demand in the nine months to October, it can be assumed that there is still free production capacity in the economy, allowing the producers to respond to any further sharp increase in demand on a timely basis, as indicated by the outstripping dynamics of consumer prices of industrials vis-à-vis producer prices, the oil industry and the energy sector excluded.[4] The growing final de-

[3] For more detailed information, see the "Demand Factors" section of this report.
[4] If there is not enough free production capacity in the economy, growing demand in the manufacturing sector may send producer prices too high and therefore exert an upward pressure on the consumer price level as a follow- up.

mand also triggered higher producer prices, with producer prices reporting an even stronger increase than consumer prices, suggesting a considerable impact of producers in the pricing process.

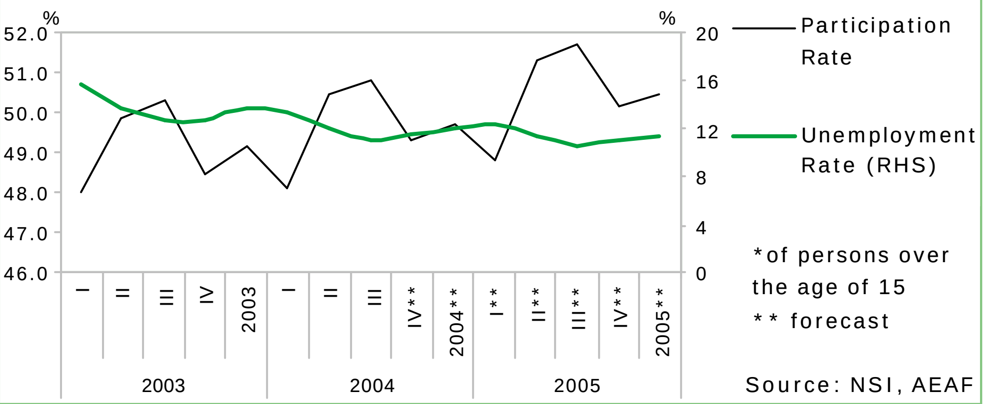
Q3 growth in agriculture and forestry ran at 5.3% due to the higher cereal yields. In addition, the expectations for a weaker performance of livestock production, the meat industry in particular, did not probably come true. The rising farm-gate and market meat prices over the last few months gave every indication of a certain decline in production. However, the estimates of the Ministry of Agriculture and Forestry point to a 6.7% increase in meat supply, fostered by higher production rather than imports[5].

Labour Market

Sustainable economic growth also led to rising employment and a declining jobless rate in the country. This was further reinforced by the active measures of the government, which contributed to the labour market upswing currently discernible.

According to the NSI labour force surveys, third-quarter employment stepped up by 3.1% on a year earlier, totalling 3 024.6 thousand. The above rise was mostly due to the jobs created in the private sector of the economy. Private-sector employment encompassed 2 097.4 thousand employed, or 7.7% (150 thousand) up relative to the third quarter of 2003. At the same time, public-sector employment went some 5.5% down on a 12-month basis. The Q3 employment trends, reported by the labour force surveys, were further evidenced by NSI data on the monthly numbers of employed and wages. According to the same findings, the average monthly numbers of employed in the economy stepped up by 4.9% due mainly to the healthy gain posted by the private sector employed (10.8% up).

Participation Rate* and Unemployment Rate



*of persons over the age of 15
** forecast

Source: NSI, AEAF

Chart 3

Q3 labour force survey data point to a steady downward trend in the unemployment rate. It went down as low as 11% of the working-age population, hitting a record low ever since the statistical office started conducting labour force surveys. The decline in the jobless rate was mainly due to the improved macroeconomic environment and boosted business activity in the private sector, but it was also partially triggered by the

[5] For further detail, see the 2003 Meat Market Situation Outlook and 2004 forecasts of the Ministry of Agriculture and Forestry, November 2004.

active labour market measures and programmes implemented by the government. However, the vacancies posted and occupied in the same period were mostly in the primary labour market, whereas labour demand under the active measures and programmes reported a notable decrease.

In addition, together with the decrease in the jobless rate, the NSI reported a 7.8% year-on-year drop in the number of discouraged. This, alongside the rising country s employment, sent the participation rate in the economy[6] as high as 50.8%, hitting a record high ever since mid-1998.

On a year earlier, third-quarter average wages went on the increase in both nominal (7.1%) and real (0.3%) terms, still running considerably higher in the public sector vis-à-vis the private sector. However, private-sector wages reported a faster real-term growth rate of 2.2% vs. a bare 0.3% in the public sector. Household budget survey data give a similar account of the wage dynamics, whereby average income from employment per household capita in the July-September period rose by 0.5% on an annual basis. Productivity[7] in the economy improved by 2.3% relative to the third quarter of 2003. Therefore, although outstripping Q3 growth in income from employment, productivity did not jeopardise the competitive position of local producers.

Financial Sector

The performance of the macroeconomic indicators shows that sustainable growth in the Bulgarian economy persisted well into the last quarter of 2004. The currency board arrangement remained stable, enhancing the country’s macroeconomic stability. As of end-December, gross FX reserves reached ÂGN 13 241.7 million, reporting a coverage ratio to reserve money (the most liquid money supply component) of 187.6%. The FX reserves dynamics over the same period was affected by the WB loan extension, receipts from privatization in the energy sector, as well as the usually strong Q3 tax revenues. The interplay of the above factors led to an increase in the government deposit.

Fourth-quarter money supply reported a sizable increase of 8.7% or BGN 1635.5 million on a quarter earlier. However, the usual December rise made a decisive contribution to broad money change. As a result of the higher demand for money at Christmas and New Year, and partially due to the budget transfers to the local governments and budgetary-sector employees, M3 in December alone stepped up by 8.2% (BGN 1539.7 million). On the bank assets side, money supply growth was prompted by the rising net domestic assets only while net foreign assets reported a quarter-on-quarter decline.

Q4 dynamics of net foreign assets was shaped by the enormous increase in foreign liabilities and a less significant rise in foreign assets. Foreign assets grew solely at the expense of BNB FX reserves. The fourth-quarter growth in foreign liabilities, in turn, was mainly spurred by the rising foreign liabilities of commercial banks, the deposits of non-residents in particular, which banks made the best use of to finance the boosted lending activity over the same period.

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[6] Of the population of 15 years of age and above.

[7] As calculated on the basis of the NSI data on GVA and the number of employed according to the labour force surveys conducted so far.

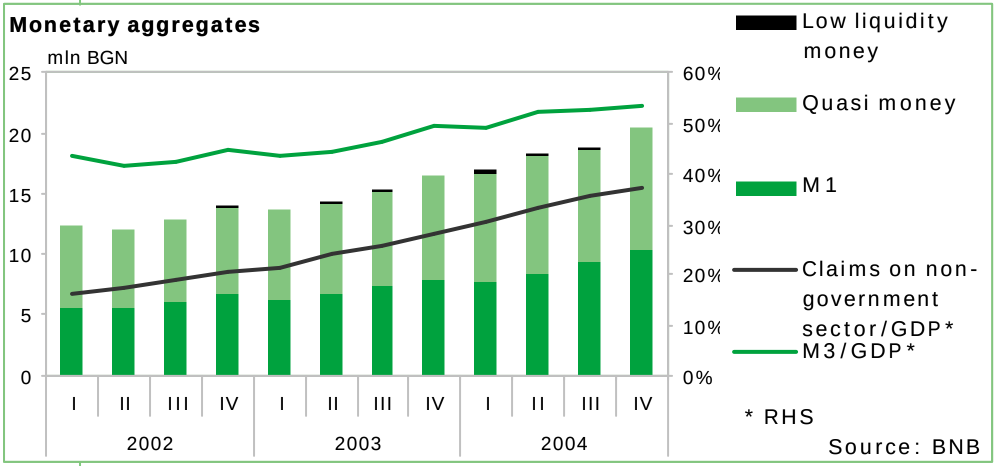


Chart 4

The robust growth in net domestic assets on a quarter earlier was mainly due to the rising claims on the non-government sector. As a result of the above-mentioned factors at work, which led to a vigorous rise in the country's FX reserves and hence the deposit of the government with the Central Bank, claims on the government sector contracted drastically in October and November. In December, however, owing to the budget transfers effected, claims on the sector reported a sound increase, bringing about a quarter-on-quarter rise. At the same time, claims on the non-government sector posted a most healthy gain, the bulk of which was due to the credit to the non-financial private enterprises. In addition, it should be noted that it was mostly mid- and long-term foreign currency loans that went on the increase over the October-December period. Household loans reported a notable rise, prevailed over by long-term consumer and housing credit.

Financial intermediation went on deepening, and in end-November bank assets ran as high as BGN 22651 million, going some BGN 1691.5 million (8.1%) up relative to end-August. Boosted lending resulted in a higher bank profit, which as of end-November amounted to BGN 421 million.

Financial Intermediation

% of GDP	Sept'03	Dec'03	Mar'04	Jun'04	Sept'04	Dec'04
Bank assets	50.10%	53.00%	57.40%	61.50%	65.90%	-
Assets in pension insurance funds	1.4%	1.6%	1.7%	1.9%	2.1%	-
Insurance premiums	1.8%	1.9%	2.6%	2.2%	2.0%	-
Stock market capitalization	7.0%	7.8%	7.3%	7.3%	7.1%	6.9%

Table 1

To put the brakes on the rampant credit growth and huge trade deficit, the Central Bank instituted a number of additional restraints, agreed with the IMF, as followed: accepting only 50% of the vault cash for minimum required reserves in force since early October; increasing the minimum reserve requirements from 4 to 8% on long-term borrowings; and writing off the vault cash from the reserves, effective from December.

As a result, the funds on the commercial banks settlement accounts with the BNB stepped up significantly, and vault cash and the resources in accounts with the Central Bank reported a 16.2% increase of BGN 276.2 million over the September-November period.

However, the measures undertaken failed to produce the desired effect. Over the September to November 2004 period loan extensions grew by 11.2% (BGN 1299 million) vs. 12.2% (BGN 941 million) on a year earlier. Consequently, commercial banks opted for restructuring their assets in investment portfolios, seeking alternative ways to attract resources by product diversification. They launched deposit-taking advertisement campaigns, raised interest and went on using credit facilities and lines in an attempt to borrow long-term resources. Credit growth, however, was covered by the growing deposit base in the economy, which is decisive for assets management. Total deposits in the September - November period went up by BGN 1329.6 million.

The higher minimum required reserves have made long-term borrowing more expensive and are likely to further limit the amounts extended by foreign financial institutions. However, credit expansion has not put the country's financial stability at risk, as the credit portfolio quality did not deteriorate.

The restrictions initiated affected not only consumer credit dynamics, which contributed to the increased consumption of imports, but corporate credit as well. Companies turned to foreign financing, resulting in higher intra-firm indebtedness and a certain rise in foreign bank credit. However, foreign bank credit is accessible only to a few larger companies with foreign interest, whereas the small and medium-sized enterprises can only rely on local bank lending, making them in the utmost exposed to the effect of the above credit expansion constraints.

The average weighted interest, representing the interest rates on all placements on the interbank money market, ranged between 1.99-2.08% over the September - November period hitting a peak in October when the demand for BGN went on the increase as a result of the higher minimum reserve requirements and corporate tax payments due at this time of the year. The interest rate spread between short-term BGN loans and time BGN deposits advanced to 6.39 percentage points as of end-November due largely to the higher interest on BGN lending.

The sustainable development of non-bank intermediation persisted throughout the year. As of end-September, insurance penetration ran at 2% (vs. 1.8% on a year earlier). Furthermore, pension insurance funds reported significant growth, with the ratios pension funds assets to GDP and gross national savings reaching 2.1 and 11.2% (vs. 1.4 and 10.6% respectively as of end-September '03). End-of year market capitalization amounted to BGN 2633 million, slightly deteriorating relative to the end of 2003. The Bulgarian Stock Exchange turnover volumes reported an over four-fold rise in the fourth quarter, going as high as BGN 1018 million. The bulk of the turnover reported was due to trading in compensatory instruments (about 34%), which gained further momentum following the public offering of the 34.78% state-owned share of the Bulgarian Telecom and the listing of new companies earmarked for privatization against compensatory instruments, sending prices rather high.

Price Dynamics

Inflation in the last months of 2004 ran as expected. Fourth-quarter inflation amounted to 2.06%. Core inflation ran at 2.64% on a quarterly basis and 1.57% since the start of the year. Unprocessed food, market fuel and service prices reported a stronger dynamics vis-à-vis the other commodity groups. Unprocessed food prices in September, November and December stepped up most vigorously by 7.28, 4.58 and 10.19% respectively. The above rise followed a distinctly seasonal pattern, although the December price increase was also associated with fears of certain imbalances in the food market. Fuel prices followed closely the worldwide crude oil price dynamics. In October, for example, when oil prices went on the increase (12% up), local car fuel prices rose by 4.47%. However, November oil prices ran some 10% cheaper and local fuel prices followed suit, dropping by 4.52%. December sustained the downward trend, and fuel prices reported a 6.31% month-on-month decrease. On a year earlier, fuel price inflation advanced by 6.74% on average, with the latters increase being passed on the other industries. Over the September-December period, city and intercity transport fares went up by 10.74 and 6.16% respectively.

In the last quarter of 2004, the USD was steadily losing ground to the single European currency to hit a trough in December. Following closely the USD/EUR exchange rate, the Bulgarian currency appreciated to the USD by 9% on a quarter earlier and 7% on a 12-month basis, perpetuating a low inflation rate.

On the whole, stepping up by a bare 0.46% administered prices had little effect, if any at all, on Q4 inflation. Heating prices went on the increase in July, as planned, but the 9.88% rise was reported (in the CPI) as late as November with the beginning of the new heating season. The impact of the higher prices was partially eased by the 4.09% decrease in the winter night-time electricity rates. Furthermore, drug prices reported a 2.79% increase.

2004 inflation amounted to 3.98%, and 6.15% on a yearly average.

Public Finance

The cash surplus of the general government budget reached a record high of BGN 1.5 billion as of end-November, accounting for some 3.9% of the 2004 GDP forecasts. Unlike 2003 when government spending picked up half-way through the last quarter, the budget now ran a surplus in November, implying that the usual spending practices could be only applied in December alone. Similar spending policies have a number of disadvantages, for they entail a huge current account deficit, rising government consumption, and last but not least growing amounts of cash in hand and hence increased bank lending. The latter, however, practically offsets the effect of withdrawing liquidity by way of government bond issues and contravenes underlying BNB policies aimed at curbing the rampant credit expansion in the economy.

Budget revenues over the September-November period stepped up mainly due to the robust tax revenue growth reported. A major reason for the above growth had to do with the rising share of imports within total consumption. Indirect tax revenues posted a most healthy gain of 28% on a year earlier, triggered by the increased imports over the same period, improved tax compliance and higher excise duty rates on some goods. At the same time, corporate income tax revenues remained unchanged on a year earlier due to the counterpoise of the 4 percentage point cut-down in the tax rate since the start of the year and higher tax base. Higher wages, employment and insurance thresholds led to a certain rise in the revenue amounts from the personal income tax and insurance contributions. On the whole, the central budget revenue overperformance amounted to 102.4% as of end-November. At preliminary estimate of the AEAF, 12-month budget revenues are expected to reach BGN 15.8 billion.

On a year earlier, budget expenditures in the September-November period went up by 11.4%, with this increase being rather evenly shared by the different expenditure items. Interest payments went on the rise while retaining their share within the expenditure total. Interest expenditures stepped up as a result of the growing domestic debt, which reported a higher share in the total government debt. The positive net issue of government securities withdrew liquidity from the banking system, putting the brakes on the lending process. However, a major disadvantage on the expenditure side, has to do with the actual fact that the government is running up liabilities and will have to, at some point in the future, meet the interest payments due, at record high levels of the budget surplus and the fiscal account. On the other hand, the December surplus is to further decline due mostly to the extra government spending having to do with the overdue payments on the part of the central government and municipalities as well as the bonus payments to civil servants and pensioners.

Forecasts

Bulgaria is a small but strongly open economy, which in turn makes the performance of the key macroeconomic indicators heavily dependent on external factors. For this and other reasons, all forecasts given below draw on assumptions as to the development of the external environment, as manifested by the dynamics of some major exogenous variables. In addition. The assumptions have been prepared by the AEAF experts and brought into line with the expectations of the international financial institutions and foreign analysts[8].

The forecasts are based on a lower BGN/USD exchange rate due to the headlong depreciation of the US currency in the last quarter of 2004. Notwithstanding some expectations that the USD will carry on losing ground down to USD 1.41 per EUR, AEAF estimates draw on the persistent current level of USD 1.31 per EUR in the first quarter of 2005 and a slight appreciation throughout the year, as prompted by the higher 12-month US inflation of 3.5% in November. Most probably, the Federal Reserve will keep raising the Feds rate in an attempt to restrict the growing country s demand, which in turn supports the weak USD. All this, coupled with some major government imperatives to curtail spending, give solid grounds to expectations that the 2005 growth in the US economy will slow down. On the other hand, any significant appreciation of the US currency is unlikely to take place, as it will make current account deficit financing more expensive.

Given the above assumptions, the expectations are for a further rise in 2005 interest rates, with the upward trend becoming all the more pronounced at the end of the year. At present, the higher USD/EUR exchange rate is not anticipated to affect the growth rate in the Euro-area. A more expensive EUR may impede imports from the area. On the other hand, the effect will be largely made up for by the fact that, a cheaper USD will promote higher growth in the US economy, giving further impetus to worldwide trade. Current forecasts, however, draw upon a higher Euro-area growth, with most underlying assumptions being based on a 2.2% growth rate in 2005, triggered by a stable domestic demand, further supported by income growth.

Compared to the previous estimates, the expectations for a prick in the crude oil price balloon have come true. Nevertheless, 2005 crude oil prices are expected to run some USD 1.5 per barrel higher than in 2004. The upward revision has been, by and large, spurred by fears of terrorist action in Iraq as well as statements on the part of some OPEC-countries about a global supply decrease. However, any such adverse development is not expected to affect the Bulgarian economy, as it will largely be offset by the depreciating US currency to the EUR, hence the BGN.

[8] An account of the basic assumptions is given in Table 2.

Economic Growth

The expectations for a 5% GDP growth in the economy are further sustained. At the same time, forecasts may seem understated, given the robust performance of the local economy in 2004, but a certain amount of conservatism is justifiable with a view to the 2004 dynamics of inventories. The 2005 dynamics of inventories is expected to run positive. However, their share within GDP is to step down to 2%, making a negative contribution to GDP growth. Therefore, investment growth in 2005 is estimated at 7.5%, despite the 2004 rate retained of gross fixed capital formation and a certain rise in its share within GDP by over 1 percentage point. The contribution of investments to GDP is to decrease from 3.5 in 2004 to some 1.8 percentage points in 2005, but is expected to be offset, in part, by the 1.2% improvement in net exports. The upbeat export expectations are further sustained, despite the adverse impact of the expensive EUR and the anticipations for a decrease in metal prices. Export forecasts for the first two quarters point to a 14% increase, also contributing to a higher Q1 GDP growth in 2005.

The 2005 consumption growth expectations have improved significantly, basing the growth estimate at 4.6%. In addition, consumption may pick up as a result of the real-term increase in wages expected. Higher consumption, in turn, will result in a higher import growth.

Balance of Payments

The 2004 trade deficit is expected to rise to some 14% of the country's GDP. On the other hand, the latest statistics indicate a sizable increase in the revenue from services and current transfers, which may cut down the current account deficit to 7.6% of GDP.

The 2004 import growth is expected to slightly outstrip exports. A major factor at play behind the strong imports over the same period has to with the still vigorous consumption associated with the growth in wages, employment, household loans as well as the deferred consumption of the past few years and upbeat expectations as to higher income in the near future. The importation of investment goods gained momentum, following suit the boosted investment activity and sizable FDI inflows into the country. In the first half-year period of 2004, the stronger Bulgarian currency to the USD made good for the higher oil prices in USD. However, average BGN prices are expected to run higher on a year earlier. At the same time, gas import prices were steadily declining while the import volumes were going on a steady increase, thus indicating the presence of a substitution effect.

In addition, having stepped up by about 20% in 2004, both import and export growth in 2005 is to slow down due to the lower import and export prices expected. Preliminary estimates point to a certain drop in the average prices of both metals and oil in 2005. As a result, the 2005 trade deficit is anticipated to steady at around 14% of GDP, and the current account deficit to amount to 7.4%.

Services, tourism in particular, are to remain a major source of revenue generation, covering about 30% of the country's trade deficit but also fostering the importation of investment and consumer goods. The 14% growth forecasts are rather conservative against the revenue performance of the preceding years but may well be surpassed,

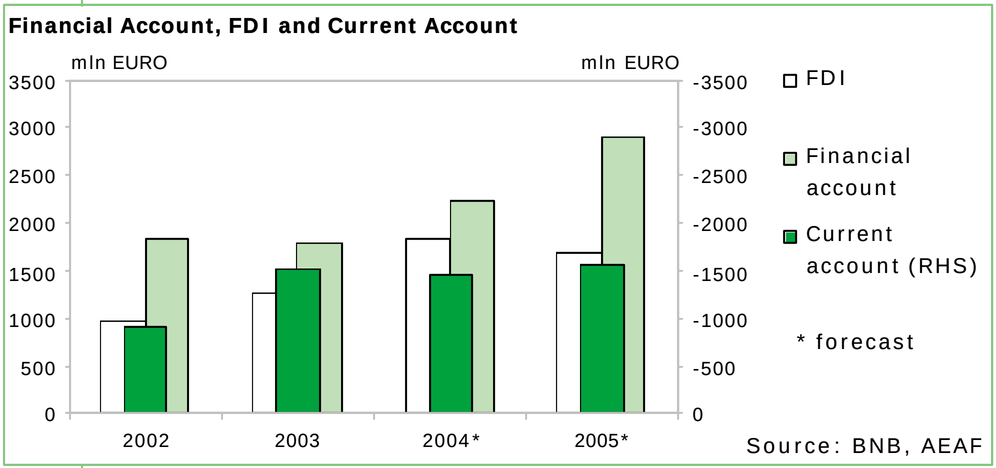


Chart 5

given a favourable environment.

Current transfers in 2004 gained in importance for the curtailing of the current account deficit. Since the increase was mainly due to the ever-rising private transfers made by Bulgarians working abroad, the expectations are that they will carry on increasing at a rather fast rate in 2005 as well, and make up for over 30% of the current account deficit. At the same time, the bulk of them may be used for the purchase of imported consumer goods, which will in turn boost imports.

The current account may deteriorate as a result of the worsening income balance, as pre-conditioned by the increased foreign ownership in the country, and hence higher interest payments on intra-firm loans and dividend payments to non-residents.

FDI into the country are expected to cover fully the current account deficit not only in 2004 but in 2005 also.

The major factor at work behind the growing inflows on the financial account has to do with the low foreign interest, which makes borrowing from abroad and lending of a higher return in BGN a worthwhile and lucrative exercise for most banks. Further-more, the financial flows are to retain their direction, as there is expected no abrupt or significant change in the interest rate difference between Bulgaria, the EU and the USA in 2005. However, any drastic turnaround in the trend may only be triggered by a dramatic clampdown on the country's credit growth.

BNB FX reserves are expected to step up significantly at the end of 2005, even in the case of a possible buy-back of the country's foreign debt.

Employment and Unemployment

The labour market dynamics of the last two years or so has been predominantly shaped by the structural reforms completed and consequently by sustainable developments underway in the country's economy. It is therefore expected that the key labour market indicators will carry on performing in a most robust manner in 2005 as well. Q4 employment is to decline due to the interplay of some end-of-year seasonal factors as well as the redundancies under some of the social programmes of the Ministry of Labour and Social Policies, sending the end-2004 unemployment rate high. On a 12-

[9] 2004 and 2005 employment estimates draw upon the methodology used in the NSI labour force surveys.

month basis, 2004 growth in employment is estimated at about 3%[9]. Though at a slower rate, the country's employment in 2005 is expected to further grow due mainly to the increased business activity of the private sector and related thereto boosted job creation and primary labour market demand. On the other hand, the government active labour market measures and programmes are anticipated to post a lesser contribution to employment growth.

Sustainable job creation in the private sector will give a further push to the participation rate in the economy of some 0.5 percentage points in 2004 up to 49.7% on a yearly average. The rate in 2005 is to step up by another 0.8 percentage points to 50.5%. The participation rate increase of the past two years implies a certain decrease in the discouraged numbers. Part of them are expected to leave the out-of-labour force cohort, as they make up the so-called "labour reserve" and will therefore join the country's work force again as a result of the Ministry of Labour and Social Policies programmes targeted specifically at the above vulnerable unemployment cohort in 2004 and 2005.

The sustainable development of the private sector is expected to make a most vigorous contribution to the smooth and stepwise reduction in the unemployment rate. The 2004 jobless rate is estimated at about 12%[10] of the country's labour force on a 12-month average. In 2005, however, unemployment is to decline at a slower rate on an annual basis (by less than a percentage point) due mostly to the downscale planned in some of the nationwide active labour market measures and programmes of the Ministry of Labour and Social Policies. Average annual unemployment in 2005 is expected to run around 11.3%. The current forecasts are based on slight changes in the unemployment dynamics relative to October estimates, stemming from a recent data update and follow-up revisions, taking into account the decreasing jobless numbers under the active labour market measures. Therefore, the active labour market measures of the government are expected to make a lesser contribution to the unemployment reduction effort, whereas next years lower unemployment will be mostly due to the sustainable job creation in the private sector.

Inflation

2005 inflation forecasts draw on a moderate increase in crude oil prices and take into account the indirect and long-drawn-out effect of the higher fuel and energy prices in 2004, while making allowances for the administered price rise planned.

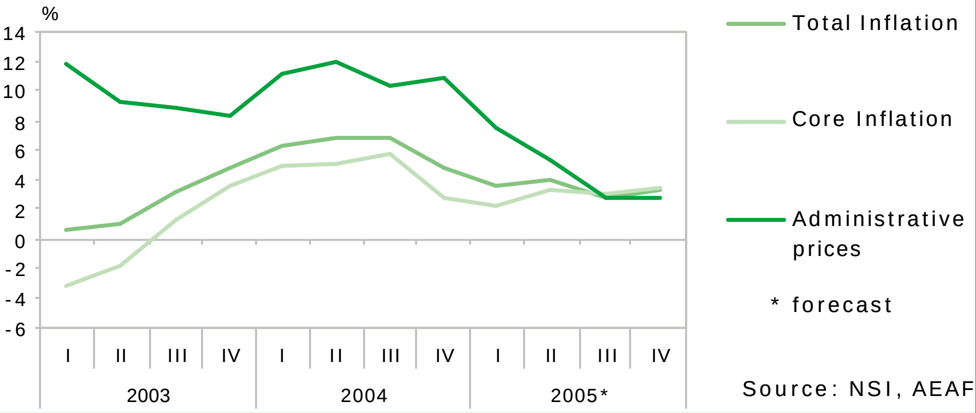
Core inflation in 2005 is expected to amount to 3.20%. Twelve-month rise in market fuel prices is projected at 4.64%. At the same time, core inflation, fuel and unprocessed food prices excluded, will run at 3.19%. Market service prices are anticipated to go some 5.53% up as a result both of the higher demand and the upward pressure of fuel price inflation in previous periods. Forecast inflation of tradebles will be at 1.5%. However, tradebles face strong competitive imports and report, as a rule, a lower price level. The contribution of core inflation to total inflation in 2005 is expected to amount to 2.41 percentage points.

Unlike the preceding years, 2005 administered price inflation is to rise by a modest

[10] By definition of the labour force surveys.

2.61% due to a number of reasons as follows: on the one hand, there is no scheduled price rise in electricity and heating as significant as the increase of the previous years. On the other, the excise duty rates on tobacco products are expected to remain relatively unchanged. Furthermore, forecasts are based on a negligible price growth in electricity and heating for household purposes and postal services. The contribution of administered prices to the country's inflation is estimated at a bare 0.65 percentage points.

Inflation, corresponding quarter = 100



Source: NSI, AEAF

Chart 6

Inflation in 2005 is expected to run at 3.06% as of the year-end, and 3.38% on a 12-month average.

Government Consumption

Government consumption in 2005 is to step down on an annual basis. The contribution of the government sector will, then, go on the decrease, running positive, though. The above estimates were mainly influenced by the lower tax rates in force since the start of 2005, the minimum budget deficit amounts projected in the IMF[11] arrangement, as well as some major alternations on the budget expenditure side.

Next years budget expenditures will be limited by the revenues in the general government budget. In addition, the vigorous revenue growth of the past two years is unlikely to be further sustained for a number of reasons having to do with the significant decrease in the tax rates on income; and a certain slowdown in the import and consumption growth. The latter factor, however, implies that the budget may no longer rely on the excessively high revenue from VAT and excise duties. At the same time, a relatively robust year-on-year increase may be expected with revenues from excise duty rates, having to do with the rise in some of the rates, but producing a rather negligible effect. However, the upcoming amendments to the income tax burden are to have a considerable impact on the budget. The aggregate loss for the budget, as incurred by the 4.5 percentage point decrease in the corporate income tax rate and the concurrent reduction in all personal income tax brackets is estimated by the Ministry of Finance at some BGN 300 million. The above estimates, on the other hand, do no take into account the effect of some of the elements of family income taxation, in force from

[11] The draft agreement between the Ministryof Finance and the IMF, which is not yet signed but fully agreed upon.

the beginning of the year, which is projected to amount to another BGN 120 million worth of a budget loss. Therefore, the tax burden reductions are expected to produce a greater impact on budget revenues vis-a-vis the positive effect to be yielded by the growth in the economy, employment and income expected. In addition, non-tax revenue performance is to further deteriorate on a year earlier as a result of the loss of dividends having to do with the privatization of large state-owned enterprises. In the final analysis, having considered the interplay of the above factors, 2005 revenues

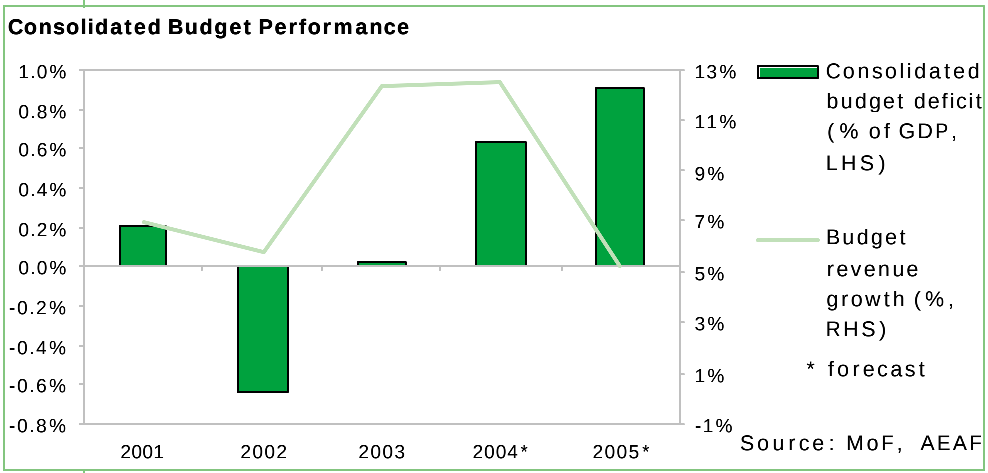


Chart 7

are to step up by about 5.3% against the 2004 revenue forecasts.

Any rise in 2005 budget expenditures will be limited by revenue growth and the assumptions as to the end-of-year budget surplus. The budget balance forecasts, then, draw on the BGN 372 million of a surplus, agreed on in the IMF arrangement instead on the deficit under the 2005 Budget Act provisions.

The fulfillment of the IMF arrangement may hardly be put at risk, as the financial discipline over the past few years has improved tremendously. However, a potentially adverse effect may have to do with the political cycle, which is likely to lead to higher budget spending and hence infringement of the budget surplus threshold, provided in the arrangement. On the other hand, AEAF estimates suggest that there is very little likelihood for the budget to run a bigger deficit than the 2005 Budget Act provisions.

The priorities on the 2005 fiscal agenda are mainly focused on the social sphere and education. Therefore, higher budget appropriations to provide for social expenditures will generally result in lower disposable resources for government spending and eventually slow down the latter s growth. The effect, however, on the country's economic growth will amount to zero, as social expenditures are transformed into private consumption on the part of pensioners and the socially aided groups. On the other hand, any higher government spending on education will bring about some alterations in the structure of government consumption, with final government expenditures rising at a faster rate vis-à-vis collective consumption.

Financial Sector

On a year earlier, money supply growth in 2005 is expected to run lower at about 17%. Broad money will step up at a slower rate mainly as a result of the weaker lending growth anticipated. Furthermore, the money multiplier is not to carry on rising any further in the same year. The above assumptions rely on the broader monetary base having to do with the higher bank reserves, which will in turn offset the healthy effect of bank lending. In 2005, the money multiplier is expected to run around 3.4 on average, with its 12-month contribution to M3 growth remaining positive as of the year-end.

2005 is not expected to witness any substantial changes in the local interest rate dynamics. Short-term deposit interest is to hold steady slightly above 3%. At the same time, interbank interest in the world financial markets have reported a certain increase. Therefore, as most local banks are at present in the utmost relying on long-term borrowing from abroad, they may, at some point, be forced to raise the interest spread on long-term deposits. As for credit interest, a more significant decrease is expected from long-term loan interest. In addition, with regard to the 2005 interest rate dynamics, the interest spread between short-term loans and time deposits is expected to further narrow, fluctuating between 5 and 5.5 percentage points.

As of end-year, 2005 claims on the non-government sector are to grow by about 30-31% on a year earlier. The expectations for a certain slowdown in lending derive from the interplay of the following factors at work: in the first place, this is the high degree of indebtedness in the economy; and secondly, the attraction of potential credit borrowers is to take place at a relatively slower pace. Besides, the share of credit in bank balance sheets may not any longer grow at the robust rate of the preceding years by further restructuring of assets. Therefore, for this and other reasons, any credit growth in the economy will be heavily reliant on the resources borrowed as well as the capacity of banks to do so. At the same, the fact remains, that more and more Bulgarian companies have been given access to the foreign credit market where interest rates run considerably lower.

Forecast Uncertainties

AEAF forecasts are based on a short-term growth scenario of the Bulgarian economy, including estimates of the economic policies currently implemented as well as the likely changes in the macroeconomic parameters that may take place. In addition, any interference on the part of the government in case of contingencies should be looked upon as emergent risks, creating a certain amount of uncertainty as regards the expectations of the economic agents. All this may affect the patterns of their market behaviour in the near future and also call for certain revisions in the performance of the model-based indicators.

With a view to the current state of affairs, forecasts uncertainties may evolve from as follows:

- Higher lending means not only higher consumer imports but also growing liabilities to the financial sector. The stability of the financial sector, at the same time, is associated with the easy access to foreign capital. However, higher foreign interest, coupled with some deterioration in the credit portfolio of the local banks, may bring about a short-lived destabilization of the country's financial system.
- A drastic cut-down in the country's credit growth may lead to a turnaround in the balance of payments financial flows.
- Also, a likely revision of food price inflation is possible depending on the 2005 crop yields.
- As a result of the market liberalization in 2004 (e.g. telecommunications) some service prices, may accordingly, go on the decrease.

Any difference in the dynamics of the exogenous factors reviewed, other than the above estimates, may result in a different pattern of performance of the key macroeconomic indicators as follows:

- a lower growth rate in Bulgaria's major trading partners is to trigger lower foreign demand and hence a weaker country's GDP growth, and a deteriorating trade balance;
- any higher rise in the international interbank interest rates expected may affect predominantly the country's balance of payments, and more specifically:
  - the amount of foreign debt payments and hence the current account income balance, which is expected to further worsen;
  - the flows on the financial account, giving rise to an outflow of financial resources, which may in turn lead to a certain credit decrease in the economy and a lower growth in investment and to a lesser extent consumption.

- The headlong depreciation of the USD to the single European currency and hence the BGN may, by and large, wear away the country's growth potential and boost imports in turn. Furthermore, a likely turnaround in the USD/EUR exchange rate is also possible in the short run due to a restructuring of the reserves of some of the worlds largest economies. On the other hand, a stronger BGN may lead to lower inflation vis-à-vis the 2005 forecasts.
- Although no oil market turmoil is expected a certain rise in oil prices may give rise to forecast uncertainties.
- A likely drop in the metal exchange prices may have an adverse effect on the value added in the economy, resulting in a lower nominal value of the country's GDP.

Macroeconomic Indicators 2003 - 2005		Reported data				Forecasts													
		2003	Q1	Q2	Q3	Q4 2004		2004		Q1 2005		Q2 2005		Q3 2005		Q4 2005		2005	
			2004	2004	2004	previous	revised	previous	revised	previous	revised	previous	revised	previous	revised	previous	revised	previous	revised
Exchange rate USD/BGN, a.a.		1.7	1.56	1.62	1.62	1.63	1.51*	1.61	1.57*	1.62	1.49	1.62	1.52	1.62	1.54	1.62	1.53	1.62	1.52
Petroleum spot price (APSP)		28.9	32.1	35.6	41.0	40.3	42.8*	37.3	37.8*	38.5	40.0	37.5	39.0	36.8	38.3	36.3	37.8	37.3	38.8
EU Area Real GDP growth %	%	0.5	1.3	1.9	2.0	2.1	2.2	1.9	1.9	2.1	2.1	2.3	2.2	2.5	2.3	2.6	2.4	2.4	2.2
LIBOR U.S. dollar deposits %	%	1.2	1.2	1.5	1.8	2.0	2.6*	1.6	1.9*	2.6	2.8	3.1	3.1	3.6	3.6	4.1	4.1	3.4	3.4
GDP, current prices	mln BGN	34 410	8 055	8 867	10 724	10 393	10 411	38 038	38 098	8 755	8 792	9 570	9 604	11 969	11 541	11 297	11 253	41 191	41 188
GNP, current prices	mln BGN	33 547	7 785	8 770	10 519	10 233	10 274	37 304	37 410	8 962	8 549	9 322	9 336	11 383	11 301	11 007	10 974	40 273	40 161
GDP, real growth	%	4.3	5.3	6.0	5.4	4.6	5.0	5.3	5.5	4.9	5.5	5.0	4.8	5.2	5.1	4.9	4.7	5.0	5.0
Consumption, real growth	%	6.6	5.2	4.2	3.0	4.9	5.2	4.3	4.5	3.5	3.4	3.9	4.6	4.8	5.2	3.5	4.9	4.0	4.6
Investment, real growth	%	16.3	42.6	17.6	7.4	10.4	10.7	16.5	16.2	6.0	5.5	9.5	7.9	10.0	9.5	9.8	7.0	9.0	7.5
Exports GNFS, real growth	%	8.0	8.0	10.9	15.6	15.7	14.2	12.8	12.5	11.7	13.6	11.1	12.6	10.6	10.2	13.3	10.6	11.6	11.6
Imports GNFS, real growth	%	14.8	17.7	11.3	13.4	15.4	14.2	14.3	13.7	8.8	9.3	10.3	12.0	11.9	12.8	11.0	9.7	10.6	11.0
Inflation, corresponding period of previous year = 100	%	2.4	6.4	6.7	6.7	4.8	4.7*	6.2	6.1*	3.5	3.5	3.7	3.9	3.1	2.8	3.4	3.3	3.4	3.4
Inflation e.o.p.	%	5.7						3.7	4.0*									3.5	3.1
Inflation, previous year = 100	%	2.4	5.9	5.7	5.7	7.3	7.3*	6.2	6.1*	3.2	3.3	3.2	3.4	2.7	2.4	4.6	4.4	3.4	3.4
Core inflation, corresponding period of previous year = 100	%	-0.1	4.9	5.0	5.5	2.7	2.7*	4.5	4.6*	2.1	2.2	3.1	3.3	3.1	2.9	3.5	3.5	2.9	3.0
Administrative prices, corresponding period of previous year = 100	%	9.5	11.0	12.0	10.4	10.9	10.8*	11.1	11.0*	7.3	7.5	5.2	5.4	3.3	2.7	3.1	2.8	4.7	4.6
Current account balance	mln EURO	-1 505	-486	-467	209	-951	-920	-1 696	-1 476	-390	-438	-521	-483	255	294	-1 042	-940	-1 696	-1 566
Current account balance, % to GDP		-8.6	-11.8	-10.3	3.8	-17.9	-17.3	-8.7	-7.6	-8.7	-9.7	-10.7	-9.8	4.3	5.0	-18.0	-16.3	-8.1	-7.4
Exports, mln. EURO	mln EURO	6 668	1 718	1 895	2 155	1 932	2 126	7 700	7 933	2 007	1 985	2 109	2 123	2 338	2 360	2 163	2 277	8 617	8 746
Imports, mln. EURO	mln EURO	8 868	2 227	2 689	2 634	2 931	3 105	10 480	10 671	2 506	2 525	2 950	2 992	2 899	2 955	3 202	3 263	11 596	11 736
M3, a.a.	mln BGN	14 723	16 769	17 160	18 560	19 000	19 289*	17 872	17 945*	19 804	21 361	20 904	22 100	22 015	23 590	23 001	24 704	21 331	22 939
Reserve money, a.a.	mln BGN	4 406	4 842	5 007	5 481	5 758	6 034*	5 272	5 341*	5 740	6 134	5 858	6 343	6 290	6 944	6 389	7 645	6 069	6 767
Tax revenues	mln BGN	11 114.1	2 933.5	3 152.0	3 053.2	3 364.4	3 444.4	12 503.0	12 689.7	3 079.4	3 129.9	3 308.8	3 351.6	3 205.1	3 321.4	3 531.8	3 722.4	13 125.2	13 525.3
Total revenues	mln BGN	14 069.7	3 640.1	4 009.1	3 767.1	4 207.7	4 216.8	15 624.0	15 838.0	3 725.6	3 799.5	4 141.8	4 224.0	3 974.8	4 053.7	4 510.2	4 599.7	16 352.5	16 676.9
Unemployment rate	%	13.7	13.3	12.0	11.3	12.0	11.6	12.2	12.0	12.2	12.3	10.9	11.3	10.1	10.5	10.5	11.0	10.9	11.3
Participation rate	%	49.2	48.1	50.5	51.0	49.4	49.3	49.8	49.7	49.0	48.8	50.9	51.3	51.5	51.7	50.0	50.2	50.4	50.5

* reported data

Table 2

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