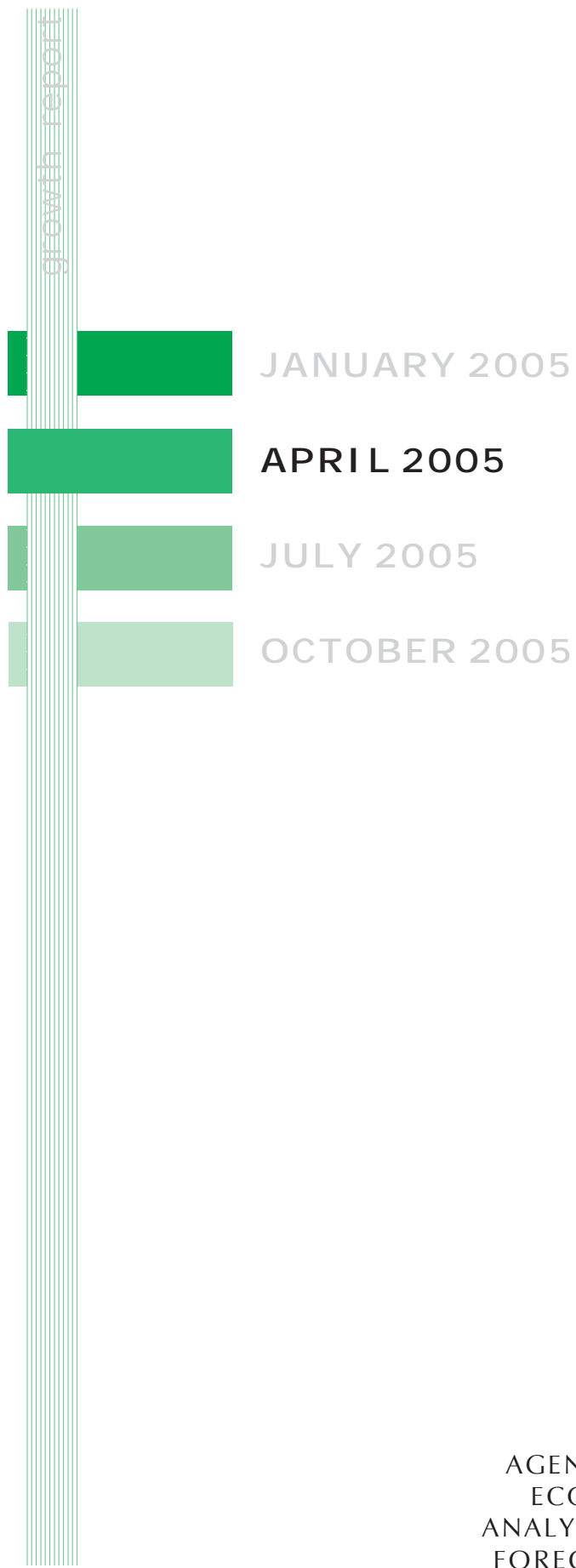
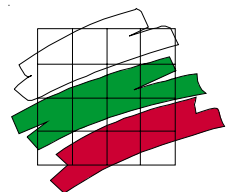


THE BULGARIAN ECONOMY: ANALYSIS AND OUTLOOK



AGENCY FOR
ECONOMIC
ANALYSIS AND
FORECASTING





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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 Performance

Fourth-quarter GDP stepped up by 6.2% on year earlier to BGN 10.5 billion (at current prices) at preliminary estimate. The robust domestic demand, as triggered by bank credit expansion in the country, resulted in an ever-worsening trade deficit (some 14% of GDP). However, the latter was fully made up for by revenues on the financial account, without putting at risk the stability of the economy. FX reserves went on the increase and the reserve money/FX reserves coverage ratio hit 198.4%. Despite the impact of some administrative and external factors, the relatively high 2004 inflation was mainly due to the more expensive end-of-period non-processed food prices and hence was not a sign of any major local market imbalances. The boosted business activity in the private sector led to a 1.4 percentage point decrease in the end-of-year unemployment rate on a year earlier. At the same time, as a result of the restrictive stance of 2004 government policies the share of government consumption declined to 18.7% of GDP and the budget ran a surplus amounting to 1.7% of GDP.

Demand Side

A major factor of growth by component of final use had to with exports with a contribution of 8.9 percentage points. Foreign demand for Bulgarian goods stepped up by 19.8% in real terms (or a nominal-term growth of 31.4%) on a year earlier due mostly to the price dynamics in the world markets. As a result of the improved terms of trade in metals, raw material exports posted the largest contribution to export growth of 40.1%. At the same time, Q4 witnessed a further slowdown in consumer goods exports due to the largest commodity group on the export list – clothing and footwear. The above slowdown can be said to account for a certain loss of competitiveness as a result of the competitive pressure of the EU market, higher labour costs and head-long depreciation of the US currency. Having taken on a steady upward trend, Q4 investment goods exports stepped up most vigorously by 30.7%. The high oil prices worldwide were growth-conducive for oil exports, which went up by over 300% or MEUR 130 on a year earlier.

The BGN's exchange rate peg to the single European currency and country's integration into the EU market have resulted in a stronger export orientation of the local producers to the EU region. About 80% of Bulgarian exports in 2004 were destined to EU (25) and the Balkan countries, and only 4.5% to the USA, 1.3% to Russia and 6% to Asia, giving rise to some normal developments but a heavy reliance on the market situation in the EU as well.

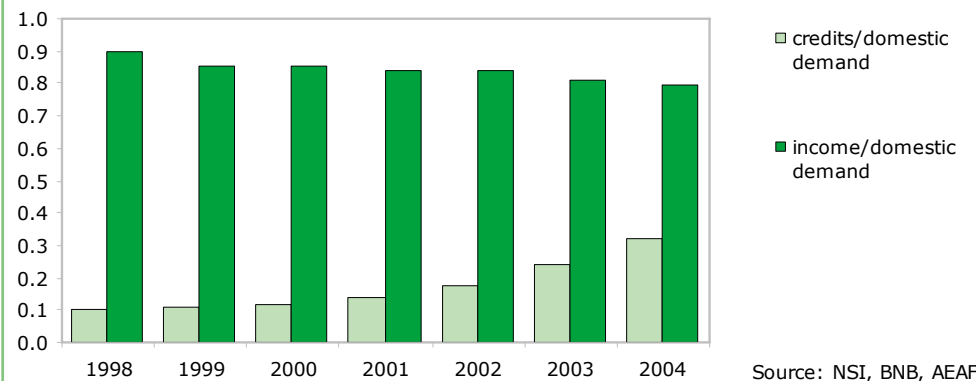
Fourth-quarter consumer demand stepped up to 6.6%. The usually high end-of-year private consumption led to a 6.8% rise in final household consumer spending. The stronger consumer demand matched the rise in employment and real wages in the same period. And last, but not least, it was the vigorous growth in bank lending – in the fourth quarter of 2004 some 3.4% of household consumption was financed by way of

loans, whereas in 2003 consumer loans amounted to 2.7% of final household spending. The altered household credit structure, favoring long-term loans indicated that a restructuring tendency in consumption was well underway.

As a result of the restrictive budget policies of the government aimed at curtailing the current account deficit, the contribution of public consumption declined to 1.4 percentage points vs. 2.7% on a year earlier due mainly to the significantly lower government consumption.

Gross fixed capital formation increased by 10%, making a 2.25 percentage point contribution to GDP growth. At the same time, inventories posted a most negative contribution of - 0.07 points. With a view to the stockpiles of the preceding quarters, such a growth distribution across the investment items and by quarter was much expected¹. The bulk of 2004 investment was financed by national savings - 40% in the fourth quarter vs. 38% on a year earlier. Investment credit growth gained further momentum. National savings stepped up by 40% on a 12-month average, whereas long-term loans, which can be said to be investment in nature, grew by about 50%. Housing loans made a 20 percentage point contribution to long-term credit growth, which fully matched the robust growth in the construction sector over last two years and high real estate prices.

Domestic Demand Financing



The accelerated growth of the economy resulted in a higher domestic demand for foreign goods, as measured by imports (its share within GDP went some three percentage points up to 68.7%). Although imports reported a lower real-term growth (16.9%) vis-a-vis exports, they proved out to be the main reason behind the external sector's negative contribution of 1.9 percentage points due to their higher nominal-term growth. In the last quarter of 2004, robust exports, the boosted investment activity and high prices in the international markets fostered raw material imports for the export-oriented industries. Following suit the growing investment activity and FDI into the country, Q4 investment goods imports posted a notable increase of 35.1%. However, in the short run the country's ever-rising investment activity may come down to a certain deterioration in the trade balance while leading to a significant mid-term improvement in capacity utilization and competitiveness. Another two import items,

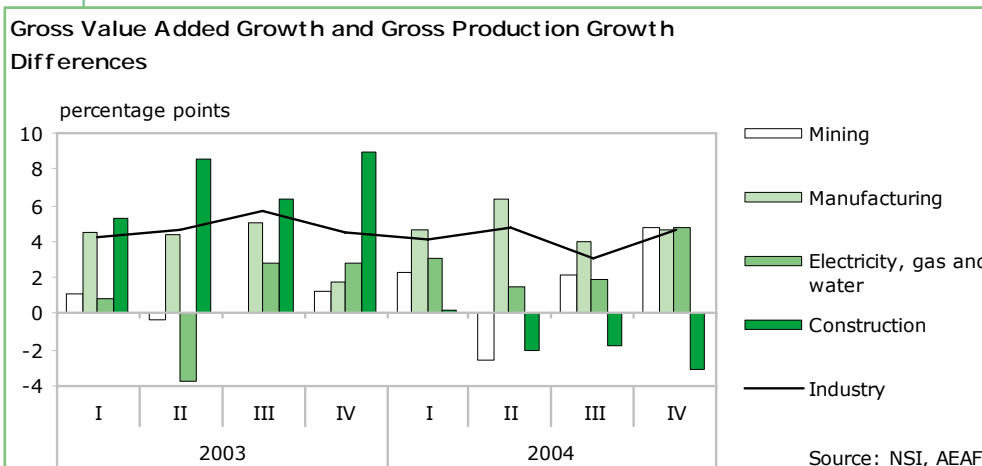
¹ For example, construction work left unfinished in the preceding months.

i.e. cars and energy goods, reported a faster growth rate. Car imports rose most vigorously by 85% as a result mainly of the altered methodology of valuation. Furthermore, if the early-2004 appreciation of the Bulgarian currency to the USD had fully made up for the high oil prices in USD, Q4 average import prices of crude oil stepped up in EUR terms as well. All this resulted in a 36.6% year-on-year rise in energy imports. Consumer goods imports went on performing rather robustly (32.2% up) due to the increased bank lending, higher Q4 consumption and orientation to foreign goods as a first choice.

Supply Side

All sectors of the economy reported a positive contribution to Q4 growth. However, the manufacturing sector posted again the most vigorous real growth in gross output vis-a-vis the other sectors. At the same time, due to the faster growth in intermediate consumption, real-term rise in value added in the sector lagged behind the service sector (4.8% growth vs. 6% in the service sector). Of all manufacturing industries it was construction which posted a most healthy gain in value added of 10.8% on a quarter earlier, and 9.1% on a 12-month basis. Value added in the remaining industries but mining reported a decline as percentage of unit production costs. The higher output growth vis-a-vis value added, which resulted in a lower share of value added in unit production costs, may be due to as follows:

- increasing competitive pressure and a decreasing profitability margin aimed at stepping up or at least retaining the present market share, which applies to the processing industries in the utmost;
- upward price pressure of raw materials, which most producers have failed to pass onto to customers. Some part of the manufacturers rely on raw material imports of rising prices, as for example electricity and heating generation subject to administered pricing, while energy prices in the last quarter of 2004 went on the increase.



The fourth quarter witnessed again the usual decrease in value added as percentage of gross output in construction and a concurrent increase in value added vis-a-vis gross output on a year earlier, a specificity of the sector's performance that can be

explained by way of the longer time it takes to accomplish construction works. Furthermore, the very process can be outlined as follows: large amounts of construction work in progress at lower prices of raw materials and follow-up sales at higher real property prices, coupled with an on-going growth in raw material prices and a certain drop of the construction work in progress in volume terms. Such growth is as a rule associated with liquidity problems, which hardly ever existed with a view to the bank credit expansion in the same year. The construction permits granted throughout 2004 stepped up by 70% and some 90% in the fourth quarter alone on a year earlier, implying a significant rise in gross output in 2005. All this will first come down to a certain growth in inventories and then to a higher value added in the second half-year period of 2005 and early 2006. At the same time, stronger supply and the relatively high prices may impede real estate transactions and hence exert a downward pressure on prices in the medium term.

The outstripping growth of export sales of 44.9% vs. only 7.7% in domestic sales in 2004 indicates that a larger amount of Bulgarian manufacturers were now enjoying a higher share in the world markets and the EU in particular. However, the textile and clothing industries did not follow the general trend underway, reporting a certain growth slowdown, with the clothing industry posting even a year-on-year decline in two months of the fourth quarter and a most drastic decrease of 25.2% in January '05 alone. The likeliest reasons for the above development seem to be associated with the removal of the import quotas for Chinese textiles in effect from 1st January 2005 and the lower level of orders for the Bulgarian manufacturers. However, if the downward trend persists well into the first quarter of 2005, most producers may be forced to alter their production and marketing strategies to fit into EU market niches where Chinese competition is not that stiff.

In the fourth quarter of 2004, the manufacture of basic metals like copper and steel remained in the lead, posting a most robust contribution to growth in the Bulgarian manufacturing sector. The higher world prices and stronger foreign demand for the manufactures of the local mining and extraction industry as well as metal production and casting were and still are heavily dependent on the rapid development of construction in the main economic zones – the USA, China and EU, where half of the copper² and some 20% of the steel produce³ is directly used. At the same time, since mid-2004 the Chinese government has been applying measures to hamstring investment growth initially in steel, aluminium and concrete production and later to the construction sector and city/town infrastructure.

Q4 exports of cast iron, iron and steel as well as of non-ferrous metals accounted for 10.1 and 10.2% respectively of total exports. The expectations as to copper prices and demand are that they will hold steady at the current relatively high levels in 2005 as well. World demand for copper runs still well above supply, and copper production, in turn, has failed to report a proportionate increase. On the other hand, the fact remains that ferrous metal price dynamics may further put the performance of metallurgy at risk.

² Source: London Metal Exchange.

³ Source: Eurofer statistics.

The service sector reported the most robust value added growth (6%), resulting in a half a percentage point increase in its share within GVA up to 62.2% on a year earlier, with trade (a contribution of 1%) and tourism (9% rise in revenues relative to the fourth quarter of 2003) being at the core of this growth.

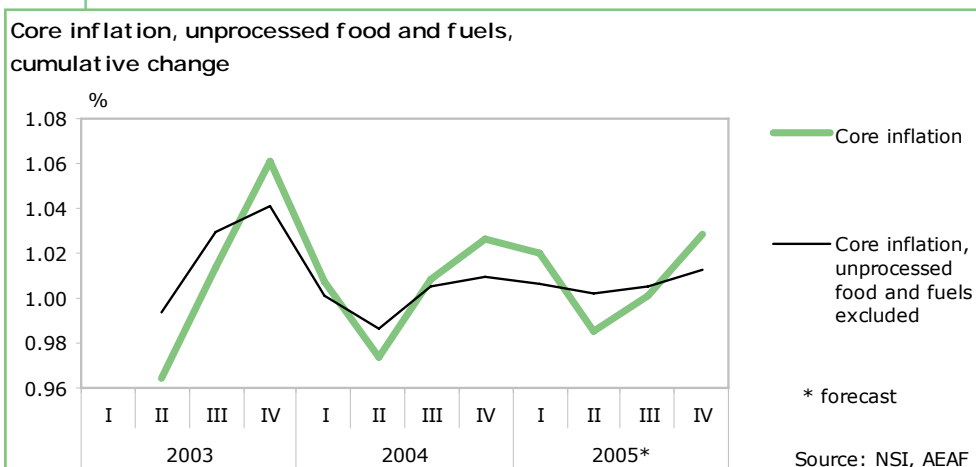
The last quarter of 2004 sustained the recovery of the agricultural sector, which posted a 3.5% growth. Sales, however, took place at lower prices (4% down) on a year earlier, indicating either a deteriorating quality of the farm produce or market oversupply⁴ and impediments to marketing, which in turn had a rather demoralizing effect on farmers.

Price Dynamics

2004 inflation totalled 3.98%, whereas consumer price inflation stepped up by 6.15%. December saw a significant price rise in unprocessed food and medicines, resulting in a monthly inflation rate of 1.26%. All this contributed to the 12-month increase in inflation while giving rise to expectations for a higher inflation rate in 2005 on a year's average.

On a year earlier, the consumer basket, used to calculate the CPI, underwent some changes having to do with the reporting of telephone services as market price items rather than administered price items in the wake of the sale of the Bulgarian Telecom in 2004.

Inflation in the two months to March'05 (period's cumulative) ran at 1.61%, whereas free market prices stepped up by 1.62%. Furthermore, unprocessed food prices in January and February went up by 3.33 and 3.89% respectively. Having steadily declined in end-2004, crude oil prices in early 2005 increased sharply, leading to a 3.32% rise in local car fuel prices in February. The price volatility of unprocessed food and fuels excluded, free market price inflation in the first two months of the year went up by a bare 0.59%.



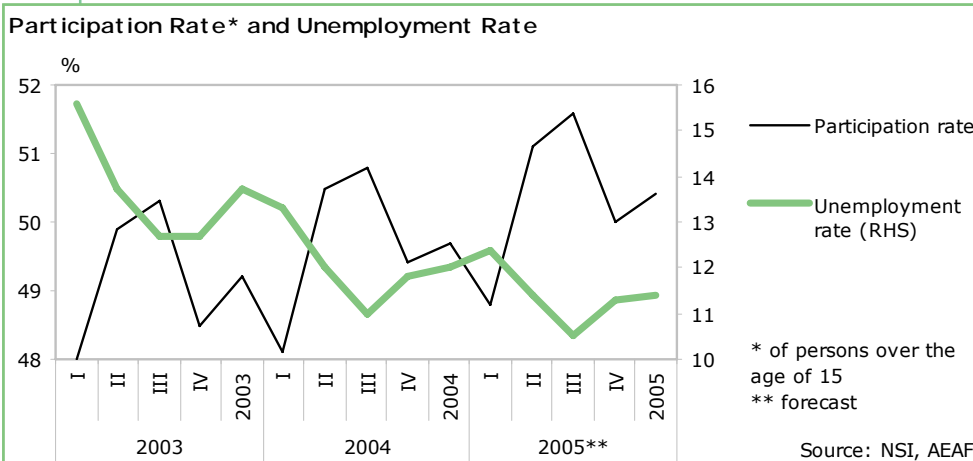
⁴ Higher production was coupled with a robust growth in agricultural imports.

The contribution of core inflation to total inflation until February amounted to 1.28 percentage points.

Since the start of 2005, administered prices rose by 1.58%. January witnessed a 3.17% increase in water supply fees as well as the institution of higher excise duty rates on tobacco products. However, unlike the preceding years the price shock of the higher excise duty rates was now perceived not in January but February when tobacco prices posted a 3.37% rise on average vs. 1.02% on a month earlier. As the fee rate of the healthcare services rendered under the National Health Insurance Fund is set as percentage of the country's minimum wages, the latter's increase resulted in a rise in healthcare fees too. Overall, the contribution of administered prices to the higher price level in the first two months of 2005 was estimated at 0.33 percentage points.

Labour Market

In the fourth quarter of 2004, the labour market reported a significant year-on-year improvement, evidencing the sustainable developments underway in the economy. The boosted business activity has led not only to income growth but higher employment as well. On a year earlier, the country's employment stepped up by 86.3 thousand or 3.1% due mainly to the intensive job creation in the private sector. However, in the second half- year period of 2004 private- sector employment reported a slower growth rate resulting in a lower country's employment relative to 2003. All this was due to the fade-out of the administrative labour market measures⁵, implemented in the preceding year and indicated that the employment dynamics was the result of the country's robust economic performance.



Q4 distribution of employment across the economy on average showed that the highest 12-month increase in the employed numbers was reported by construction (17.8% up), fully matching the data on the rapidly improving business activity in the sector. At the same time, relative to the same period, Q4 average employed numbers declined in industries where the restructuring exercise had not yet been accomplished, e.g. mining and extraction, as well as in industries still dominated by state interest and not

⁵ Obligatory registration of labour contracts with NSSI authorities.

yet privatised – electricity, gas and water generation and supply, transport and communications. The higher Q4 employment on a year earlier seemed to be the main reason behind the one percentage point increase in the participation rate up to 49.4%. However, the latter indicator's performance was also affected by the lower discouraged numbers in the economy (15.5% down), prompting some part of the out-of-labour market cohort to join the country's work force again.

The active labour market measures and programmes had a lesser effect on employment promotion due mainly to the primary labour market upswing over the same period (Q4 number of unemployed starting new jobs went up by 41.7% on average on a year earlier).

According to labour force survey data, Q4 unemployment rate held again steady at a 12-year low on average. On a year earlier, the jobless rate ran some 0.9% down to 11.8%. As a result of the narrowed scope of the active labour market measures planned, 2005 unemployment is to decline at a slower rate. February unemployment rate remained unchanged at 13.1% on a month earlier while running a 1.1 percentage point lower than in February'03.

On a year earlier, gross valued added growth per employed stepped up to 2.3% in the last quarter of 2004. At the same time, average wages reported a faster real-term increase of 3%. Unlike the preceding year, however, the two indicators now ran closer together.

Balance of Payments

As estimated by AEAf, the country's trade deficit and current account deficit in 2004 stepped up to 14 and 7.5% respectively of GDP. Revenue from services and current transfers gained in importance in covering the trade deficit, though partially only. Revenue from tourism reported again a steady growth of around 20%, indicating that the industry was developing rather vigorously by and large due to the investment-boosted infrastructure improvement. Furthermore, current transfers produced an even stronger effect on the current account balance as a result of the ever-growing private transfers.

As in 2003, the 2004 financial account ran a sizable surplus fully covering the current account deficit. This was largely the outcome of the higher amounts of foreign loan extensions to the non-financial sector as well as the increased deposits of non-residents with the local commercial banks having to do with the low foreign interest. In addition, a vast amount of last year's cash flows into the financial account was associated with the MobilTel transaction.

The *mergers and acquisitions* sub-item excluded (- MEUR 649.5), net FDI reached some MEUR 2132.5, running 1.5 times higher than the current account deficit. Revenues from privatization also went on the increase (MEUR 936.3) as a result of the sale of the Bulgarian Telecom and the receipts from the electricity distribution companies reported in December.

The financial account deficit in January this year was solely prompted by the ahead-of-schedule payments on Bradies.

Financial Sector

The possible financial risks from the point of view of the ever-growing trade deficit and likely deterioration of banks' credit portfolio forced the Central Bank to initiate a series of restrictive measures in an attempt to put the brakes on the rampant credit growth in the economy. Tough as they may have been, the measures implemented in 2004 failed to produce the effect desired but curtailed credit growth down to only 48% from 49.4% on a year earlier. However, the commercial banks followed the same pattern of behaviour and made the most of the higher credit demand to gain a larger market share. As a result of the aggressive credit policy stance upheld by banks in early 2005 (posting a 12-month growth of 47.4% by February'05), bank profit stepped up by 8.9% as of end-February on a year earlier. Relative to the same period, the ratio of net income from interest and dividends to profit went up most robustly to 223.5% (vs. 184.2% at the end of February'04). At the same time, both operating costs and provision allocations went on the increase, with the latter implying a likely deterioration in the credit portfolio of banks.

In early 2005 BNB responded by instituting another series of restrictions – amending the regulations on minimum reserve requirements whereby commercial banks shall deposit additional minimum required reserves, have they not fulfilled the following two provisions: first, credit growth should not run higher than 6% in a given quarter and accordingly 12, 18 and 24% in two, three and four quarters, and; second, the ratio of loans to the risk-weighted off-balance sheet items⁶ shall not exceed 60% of the money borrowed. The above restraints are, however, too tough and most banks are likely to dodge them for fear of losing vast amounts of money in the form of interest on their settlement accounts with BNB. It is also possible that banks try to avoid satisfying the second provision by raising their own capital. Any further borrowing of funds from abroad may well be abandoned since these funds are not taken into account in calculating the credit (minus own capital)/borrowed funds ratio. In addition, they may prove out to be rather expensive, as additional reserves may need to be deposited. On the liability side, however, the last three months witnessed a certain rise in the funds borrowed in the form of subordinated loans. Commercial banks may further seek to increase these liabilities favouring the above ratio.

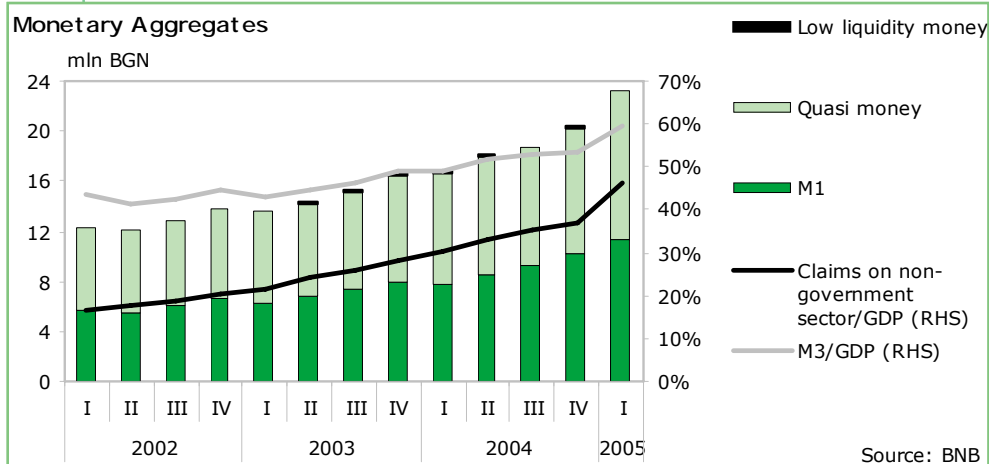
On the other hand, it is too early to say what the effect of the measure will be, as the banks are expected to respond in a different way depending on the specificities of their balance sheets. Following the announcement of the new restrictions, the banks rushed to offer lower credit interest rates on a promotional basis by end of the first quarter in attempt to make the most of lending in a very short period and achieve a comparatively higher credit base used to calculate the credit growth rate at the time the measures took effect⁷. Despite the lowered deposit interest, the average interest rate spread between short-term BGN loans and time BGN deposits went on narrowing throughout the December-February period to hit 5.03 percentage points due wholly to the lower interest on BGN loans. The average weighted interest, accounting for the interest rates on all placements on the interbank money market ranged between 1.92-1.99%, hitting a peak in December when the demand for BGN resources went on the increase, triggered by the amendments⁸ to Regulation № 21 on minimum reserve requirements.

⁶ Minus banks' own capital.

⁷ The base period for defining the additional minimum required reserves started on 1st April 2005.

⁸ In force since 6th December 2004.

In order to gauge interest in the interbank market where trading is most brisk, BIR setting has undergone some alterations (effective from 1st February 2005) as followed: the base interest rate is now set as the arithmetic mean of LEONIA (Lev Overnight Index Average)⁹ values in the working days of the preceding calendar month (base period) and applies from the first to the last day of the calendar month it refers to, making BIR independent of the issuing schedule of government securities. And last but not least, tying the base interest rate down to interbank interest (overnight) is an important step towards convergence to the Euro area.



In January and February money supply reported the usual early-year moderate rise of 0.6 and 1.1% respectively. The positive broad money dynamics in the first two months of 2005 was solely due to the growth in the net domestic assets posted, as net foreign assets decreased as a result of the decline in BNB FX reserves¹⁰.

As of end-March, FX reserves reported a year-on-year increase of 25.8% due to the positive net issue of government securities, tax revenues in the accounts of the government and receipts from privatization in the energy sector. Though in a lesser degree, the revaluation of monetary gold in the assets of the Issuing Department at market prices (in compliance with the latest amendments to the BNB Act¹¹) had a rather healthy effect on FX reserves. The FX reserves/reserve money coverage ratio reached 198.4%, evidencing the stability of the currency board arrangement.

Over the period surveyed, the capital market, too, performed in a rather robust manner, keeping the upward trend going throughout the first quarter. The above development was mainly triggered by the country's macroeconomic stability, upbeat expectations of the market players, deepening financial intermediation and the forthcoming accession to the EU, which sent the share prices rather high and led to a sizable increase in the Bulgarian Stock Exchange turnover volumes. Q1 stock exchange turnover accounted for about 62%¹² of the 2004 total. The most significant event in the three months to April had to do with the sale of some 34.78% of the Bulgarian Telecom's

⁹ A reference index of overnight deposit transactions in BGN.

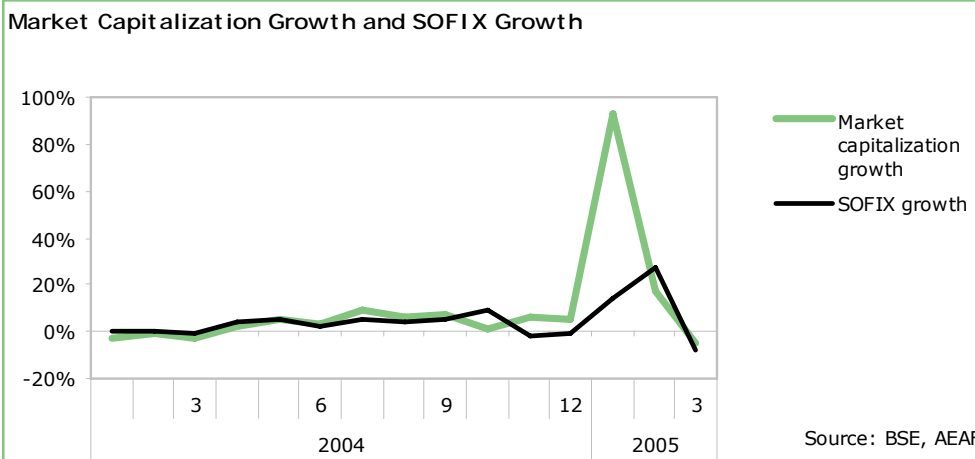
¹⁰ January saw an ahead-of-schedule buyback of Bradies.

¹¹ Prior to the amendments to the BNB Act effective from 1st February 2005, monetary gold was valued at market prices, which, however, could not run in excess of BGN 500 per troy ounce.

¹² The privatization deals excluded. If, however, the volumes in the privatization segment of market are taken into account, the turnover amounts will account for 97% of the 2004 total.

capital on the stock exchange, sending the share prices of the other companies on the increase. In addition, the public offering of the company's share capital affected the prices of the compensatory instruments, which soared to 113% of their face value immediately before the opening of the trading sessions.

In January and February the SOFIX advanced by 14.3 and 27% respectively due to the capital market upswing reported. The upward market trend was fostered by the high estimate of the investors as to the companies traded as well as the investment incentives pursuing higher capital gains, which in turn resulted in higher share prices. However, the end of February heralded a certain slowdown in trading, accounting for the price corrections underway. A most notable price drop was posted by the larger companies, as indicated by stock market capitalization and SOFIX data. In February, stock market capitalization lagged well behind the index's growth, demonstrating that the prices of the companies making up the SOFIX tended to step up at a significantly faster rate than the share prices of smaller companies and accounting for the latter's steeper decline in a time of price correction.



Public Finance

As a result of the strongly restrictive fiscal policies, the general budget started the year with a cash surplus, reporting a 13-year precedent. The surplus in February stepped even further up, hitting some BGN 134.4 million in the two months to March. The tendency of the budget towards surplus generation was indicative of a certain amount of conservatism of the budgeting exercise, i.e. non-compliance with one of its key goals – clear-cut and precise planning of revenues and expenditures.

The main reason behind the surplus was associated with the robust revenue performance. Contrary to the expectations of AEF analysts as to a turnaround in the last two years' trend and hence a slowdown in the revenue growth, central budget revenues in the two months to March posted a 22% rise. The above growth was prompted by tax revenues and, in a lesser degree, by non-tax revenues, which, however, posted a higher percentage increase. As a result of the lower tax rates applied since the start of the year, direct taxes reported a rather negligible year-on-year change: revenues from the personal income tax rose only slightly, whereas profit tax revenues contracted insignificantly. At the same time, revenues from all indirect tax items stepped up by over 21% due to the import growth in the same period. Revenues from excise duties

reported a most healthy gain of 43%, spurred by the higher revenues from fuel excise duties (most oil companies started the year with large amounts in stock). Furthermore, revenues from social insurance contributions registered a significant increase having to do with the higher country's employment, on the one hand, and rising minimum wages and social insurance thresholds, on the other.

Unlike revenues, budget expenditures in the two months to March'05 stepped up by only 6%. The increase was mainly prompted by the higher transfer amounts to insurance funds and local governments. The remaining expenditure items performed in a more or less even pattern. Capital expenditures reported the usual early-year decrease (26% down). Total interest expenditures remained unchanged on a year earlier, with the domestic/foreign interest payments ratio changing as followed: domestic interest payments went up by 16% as a result of the increase in the domestic debt in both nominal terms and as percentage of the government debt total. The sizable end-of-year budget surplus made it possible for the government to conduct another ahead-of-schedule buyback (28th January) of some part of the country's foreign debt¹³, worth USD 937.5 million – the face value of the bonds for outstanding interest (IAB). It is also very likely that the government carries out another buyback of FLIRBs ahead of the repayment plan on the next possible date – 28th July.

¹³ Following the buyback of July 2004.

Forecasts

In the last two months oil prices went on the upswing due to the short-lived undersupply in the market and statements that global demand may never be satisfied in the long run. Although the team of AEAF analysts believe that the high oil prices are mostly speculative in nature, the assumptions have been revised upwards to about USD 8 per barrel on average. Following the sharp rise at the end of the first quarter, Q2 prices are likely to remain rather high only to go on the downturn in the second half-year period of 2005¹⁴.

Oil price dynamics affected some underlying assumptions. The Federal Reserve went on raising the Fed's rate in an attempt to offset inflationary expectations. Although US inflation in the last three months stepped down from 3.5 to 3% on an annual basis, there are still fears that it may pick up speed. All these developments affected the LIBOR, which posted a rather vigorous Q1 rise. However, relative to some earlier estimates, the rate is not expected to report any significant change at the end of the year. And yet, due to the early-year rise it is anticipated to run some 0.3 percentage points higher on a 12-month basis.

High oil prices had an adverse effect on the Euro area, bringing about a certain growth slowdown of 0.6 percentage points on average. As a result the European Central Bank is not expected to raise the refi rate in so much as Euro area inflation runs comparatively low vis-a-vis inflation in the USA and around the ceiling the ECB aims at. This, however, may lead to a broadening interest rate difference between the US currency and EUR and hence end-of-year appreciation of the USD relative to some earlier forecasts.

Economic Growth

2005 GDP growth expectations run at 5.2%, or 0.2 percentage points higher vis-a-vis earlier projections. The upward revision was brought about by the higher growth rate expected of all GDP components on the demand side.

The high Q1 growth of 5.9% was due to the rising consumption and exports as well as the stronger investment growth on a quarter earlier. The expectations for lower investment growth in some earlier estimates were mainly triggered by the negative contribution of inventories in the first quarter. Judging by the January performance of the sales and output indices in the manufacturing sector, Q1 change in inventories is estimated at about BGN 230-250 million. This, together with the unfinished construction works, give solid grounds to expect that the above adverse effect is to fade gradually away. For this and other reasons, the investment growth projections have been revised

¹⁴ Any further rise in oil prices will bring about a certain slowdown in global growth, a decrease in demand and hence a price drop.

upwards by about 4 percentage points. The first quarter of 2005 is anticipated to sustain the robust export growth of last year's fourth quarter, as a result of which the contribution of net exports is to improve up to -1.3% vs. -6.5% on a year earlier. Furthermore, Q1 growth was also due to consumption. The 2 percentage point rise in consumption on a quarterly basis was mostly boosted by final household consumer spending. Relying on data of the January household budget surveys¹⁵, consumption (factor and non-factor services) is expected to gain further momentum. At the same time, Q1 consumption was also, by and large, spurred by the BNB measures to put the brakes on the rampant credit growth in the economy, effective from 1st April, resulting in higher loan extensions in March.

Q3 growth is to step further up due mainly to the upbeat expectations as to a high holiday season in 2005.

Balance of Payments

According to AEF estimates, the 2005 current account deficit is to amount to 7.7% of GDP, slightly worsening vis-a-vis January forecasts (7.3%) due mainly to the higher trade deficit, expected to reach some 15% of GDP. Forecast revisions have been made as a result of some underlying assumptions as to significantly higher world prices, in particular of energy products and metals on a quarter earlier. The expectations are that the stronger foreign demand will lead to a 3.9% rise in the export deflator and a 12.3% real-term increase in exports. At the same time, imports will be, in addition, fostered by the growing consumption and investments in the country. Furthermore, imports for the export-oriented industries are expected to go on the increase, prompted by the upbeat expectations for robust exports and high prices. The modernization of the Bulgarian Telecom and electricity supply companies recently privatised will boost the importation of investment goods. Drawing upon the above assumptions, AEF analysts expect imports to step up by over 12%, given a deflator of around 4%.

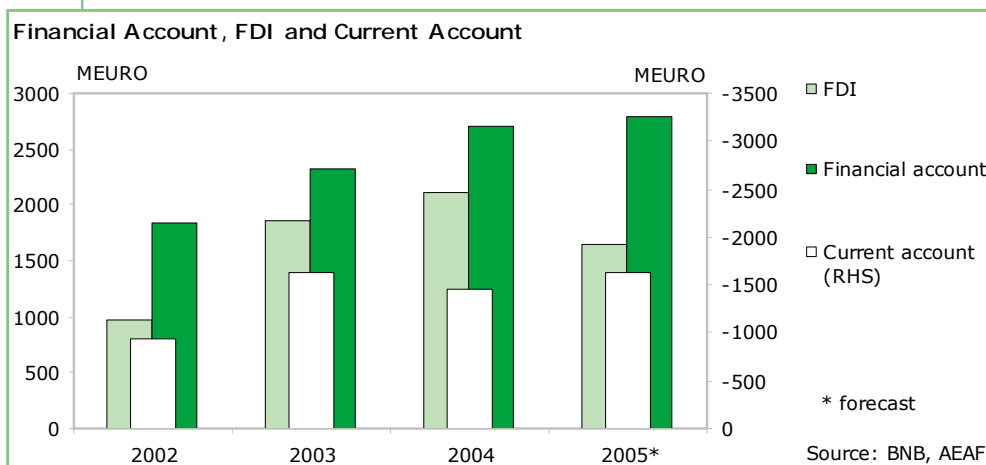
Net services will carry on covering about 30% of the country's trade deficit. Tourism is expected to be again a major source of revenue generation. At the same time, the rapid development of the service sector will call for higher investment and consumer imports. Revenues from tourism have been revised upwards from 14 to 17%, reflecting a rather moderate growth rate against the vigorous performance of the past two years.

In 2004, current transfers gained in importance in curtailing the current account deficit. As this was largely due to the inflow of private transfers, current transfers are anticipated to go on increasing at a rather fast rate, making up again for over 30% of the trade deficit. However, vast amounts of these have been used for the purchase of foreign consumer goods, boosting, in turn, import growth.

Any further current account deterioration will have to do primarily with the income balance due to the increased foreign ownership in the country and hence higher interest amounts on intra-firm debts and dividend payments to non-residents.

¹⁵ Source: NSI.

FDI into Bulgaria are expected to go as high as MEUR 1652.3, providing for the 2005 current account deficit. Revenues from privatization are to amount to some MEUR 227 (including the sale of some of the electricity supply companies).



Despite some underlying expectations for higher US interest rates, the financial account inflows are not expected to report a major turnaround in trend, as interest in EUR and the high return on loans in BGN are to be retained. The restrictions undertaken by the Central Bank to reduce credit growth in the economy will only partially affect the external financing of commercial banks while prompting the non-financial sector to more active borrowing from abroad. In addition, the financial account is anticipated to fully cover the current account deficit, providing for the necessary resources for imports.

The huge current account deficit projected may be viewed as a potential risk for a developed economy but is a normal development for a small, open and rapidly advancing economy and is therefore not expected to give rise to fears of any macroeconomic instability as long as it doesn't exert any downward pressure on BGN FX reserves and domestic savings.

As of end-2005 the foreign exchange reserves of the Central Bank are to go on the increase, despite the buyback of the country's foreign debt.

Employment and the Jobless Rate

At AEAF estimate, the labour market upswing is to persist well into 2005, as perpetuated by the country's macroeconomic stability and sustainable growth. However, employment growth¹⁶ is expected to somewhat slow down to 2.1% on a year earlier due mainly to the weaker effect of the active labour market measures and programmes of the government. This is also the reason why the jobless rate will decline at a slower rate relative to the same period. The 2005 unemployment rate¹⁷ is expected to average 11.4%, running some 0.6 percentage points down on a year earlier.

¹⁶ 2005 employment forecasts have been based on the methodology of the labour force surveys.

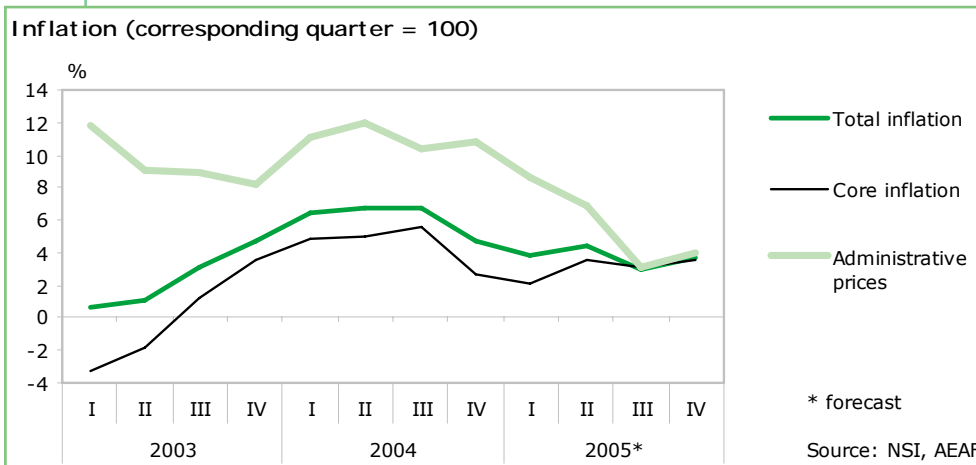
¹⁷ By definition of ILO.

The increased employed numbers will be mainly due to the boosted business activity in the private sector leading to a stronger demand on the primary labour market and new job creation. Furthermore, the privatization-related restructuring underway will foster private-sector employment. Also, the rapid development of the private sector anticipated indicates that average productivity in the economy is to follow a faster rate on a year earlier. The indicator is to go as high as some 3%, as will average real wages (3.3%).

Sustainable job creation in the private sector will also bring about the long expected rise in the participation rate, which is to step up by 0.7 percentage points on average on a year earlier to 50.4%. The higher participation rate allows for assumptions as to a certain drop in the discouraged numbers. Therefore, the stable improvement of the labour market is expected to further encourage the out-of-the labour force cohort to join the country's work force again.

Inflation

December'04 inflation ran higher than expected. In addition, unprocessed food prices were steadily rising in the first two months of 2005. At the same time, crude oil prices went on increasing and are expected to run well above USD 45 per barrel on a year's average. The interplay of the above external and home factors led to higher inflation vis-a-vis preliminary estimates.



2005 core inflation is expected to amount to 3.33%. Due to anticipations for an ever-going rise in crude oil prices, 12-month increase is estimated at 4.08%. Market service prices are to step up by 5.77% as a result of the rise in some of the items and stronger demand. The price volatility of food (unprocessed food in particular) and effect of the higher fuel prices excluded, 2005 core inflation will be down at 2.68%. The contribution of free prices is to run at 2.62 percentage points.

Administered price inflation in 2005 is to go up by 3.73%, running lower relative to the preceding years. At the same time, heating and electricity are expected to report a negligible price change. The contribution of administered prices to total inflation is to amount to 0.8 percentage points.

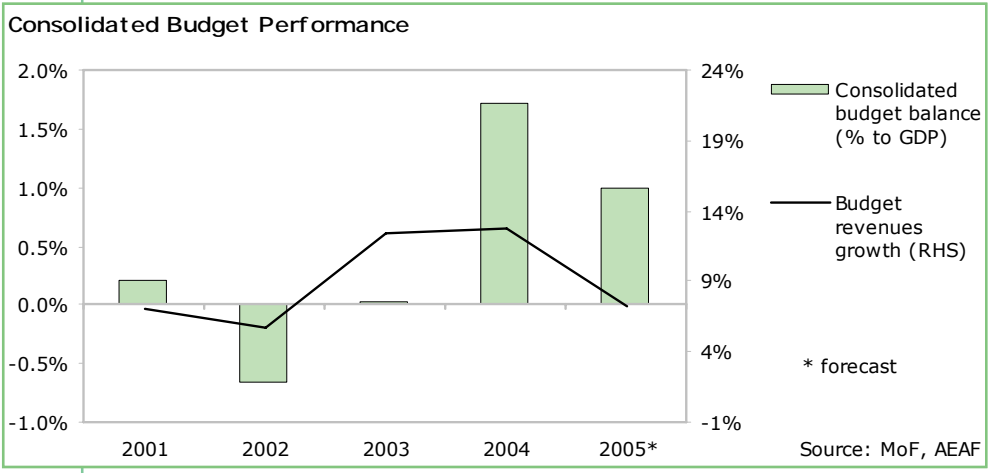
2005 inflation is expected to run at 3.42% as of the year-end and 3.7% on a year's average.

Government Consumption

2005 projections point to a negligible increase or retention of the growth rate of government consumption. This in turn will result in a year-on-year rise of 0.3 percentage points in the government sector's contribution to economic growth. The reasons behind the above revisions had to do with the higher revenue expectations and concurrent retention of the government surplus.

The 2005 forecasts as to total general budget revenues and grants have been revised upwards by BGN 323 million (1.9%) due to some underlying assumptions that the robust revenue growth of the past years will be sustained in the first quarter of 2005 as well only to begin steadily declining afterwards as a result of the nominal growth slowdown in imports and consumption. That is why the Q1 tax revenue updates account for 73% of the 2005 revisions of total revenue and grants.

Based on the budget performance in the first two months of 2005, AEF estimates indicate that direct tax revenues will remain unchanged throughout the quarter. As for revenues from excise duties, the forecasts have been revised upwards on a 12-month basis too with a view to the reestablishment of the higher 2004 duty rates on tobacco products. Despite the reduced corporate tax rate in force and lower amounts of January and February revenue collections, Q1 revenues from the above tax item are expected to step up as a result of the higher compensation payments in March. Non-tax revenue estimates have been so revised as to reflect a new pattern of total revenue distribution on a quarterly basis in favour of Q1 revenues. Based on the above revisions, 2005 growth in total revenues and grants is estimated at 7.2%, given the budget performance in 2004.



The tough fiscal discipline of the last few years will provide for compliance with the spending ceilings laid down by the 2005 Budget Act. AEF analysts expect the fiscal restriction to be sustained throughout the first half-year period. Forecasts draw upon a cash surplus of the general budget amounting to 1% of GDP, taking into account the country's arrangements with the IMF (vs. 1.7% on a year earlier, indicating a certain easing of the fiscal position). Furthermore, the above goal is to be attained by way of

contingency reserves (1% of GDP) and some 0.7% of discretionary spending postponed to the fourth quarter.

Financial Sector

Money supply growth in 2005 is expected to run higher than on a year earlier at about 25%. Broad money will increase most vigorously, fuelled by the robust growth in lending to the private sector. Despite the hard constraints on credit growth, commercial banks remain unwilling to keep their credit portfolio within the restrictions set, notwithstanding the fact that they need to put aside sizable provisions. Money supply is not to report the usual end-of year growth with a view to the IMF agreement as to the budget surplus. However, it may be further pumped up in relation to the upcoming parliamentary elections.

It is also possible that the average money multiplier in 2005 goes well below 3, with its contribution to money supply growth running negative on an annual basis due to the sharp increase in bank reserves (hence monetary base) expected in the second half-year period, spurred by bank lending policies.

The new restrictive measures of the Central Bank will come down to: a follow-up consolidation of the larger banks, which are major lenders, and some smaller banks whose credit portfolio does not enjoy a significant share of the resources borrowed. It can therefore be expected that competition in deposit taking will become stiffer, bringing about a possible increase in deposit interest. On the other hand, the Central Bank's restrictions and rising interbank interest rates in the international markets may spur a turnaround in the ever-declining credit interest, leading to a gradual and steady narrowing in the interest rate spread between loans and deposits to around 5%.

Given the current state of affairs and despite BNB constraints, 2005 credit growth is estimated at about 40%. As for the FX credit structure, the share of EUR-denominated loans is to step up even further, as will the share of long-term loans at the expense of mid-term credit.

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.

Forecast errors may evolve as follows:

Domestic factors: a likely revision in food price inflation depending on the 2005 crop yields.

Any drastic reduction in the country's credit growth may lead to a turnaround in the balance of payments financial flows.

External factors:

A drop in the main commodity prices: the robust Chinese demand is one of the reasons for the current high steel prices worldwide. However, steel prices may go on the downturn as early as the first half-year period of 2005, as the economy cools gradually down and China becomes a net exporter from a net importer of steel. At the same time, if growth in Chinese exports is further sustained, having in mind that most world manufacturers operate close to full capacity, prices are likely to report a sharp change. Such a development may be detrimental to the local producers of steel and the manufacturing sector as a whole, since the steel industry enjoys a significant weight in the sector.

In the short term, the USD/EUR exchange rate may undergo some abrupt changes having to do with the restructuring of the reserves in some of the big economies. Following Russia and Japan, where it has been already completed, China may turn out to be the next likely source of such shocks, as it intends to broaden the exchange rate band of its national currency.

Furthermore, crude oil price dynamics remains a serious risk that may jeopardise current forecasts.

In addition, the above estimates do not take into account a likely increase in net income in the balance of payments, which may produce a rather unhealthy effect on the country's trade deficit and inflation.

Macroeconomic Indicators 2003 - 2005

	Reported data										Forecasts										
	2003		2004		2004		2004		2004		2004		2005		2005		2005		2005		
	Q1	Q2	Q3	Q4	Q4	Q4	Q4	Q4	Q4	Q4	Q4	Q4	Q1	Q2	Q3	Q4	Q4	Q4	Q4	Q4	
Exchange rate USD/BGN, p.a.	1.7	1.56	1.62	1.60	1.51*	1.51	1.57*	1.57*	1.57*	1.57	1.49	1.52	1.52	1.54	1.54	1.53	1.55	1.52	1.52	1.53	
Petroleum spot price (APSP)	28.9	32.1	35.6	40.6	42.8*	42.8	37.8*	37.8*	37.8	37.8	40.0	46.2	39.0	47.3	38.3	37.8	46.3	38.8	38.8	46.8	
EU Area Real GDP growth %	0.5	1.4	2.1	1.8	2.2	1.6	1.9	1.7	1.7	1.7	2.1	2.2	1.5	2.3	1.8	2.4	2.1	2.2	2.2	1.7	
LIBOR U.S. dollar deposits %	1.2	1.2	1.6	2.0	2.6*	2.6	1.9*	1.9	1.9	1.9	2.8	3.2	3.1	3.5	3.6	4.1	4.1	3.4	3.4	3.6	
GDP, current prices	34 547	8 004	8 807	10 685	10 411	10 512	38 098	38 008	38 008	38 008	8 792	8 889	9 604	9 530	11 541	11 590	11 172	41 188	41 188	41 182	
GNP, current prices	33 439	7 737	8 700	10 499	10 274	10 407	37 410	37 342	37 342	37 342	8 549	8 483	9 336	9 321	11 301	11 425	11 004	40 161	40 161	40 234	
GDP, real growth	4.5	4.5	5.5	5.8	5.0	6.2	5.5	5.6	5.6	5.6	5.5	5.9	4.8	4.8	5.1	5.6	4.3	5.0	5.0	5.2	
Consumption, real growth	6.6	5.3	4.3	3.7	5.2	6.6	4.5	5.2	5.0	5.0	3.4	5.4	4.6	4.6	5.2	4.3	4.9	4.6	4.6	4.7	
Investment, real growth	18.2	38.0	15.0	8.0	10.7	8.2	16.2	14.8	14.8	14.8	5.5	9.5	7.9	7.9	9.5	8.2	7.0	7.0	7.5	8.0	
Exports GNFS, real growth	8.0	7.0	10.6	14.1	14.2	19.8	12.5	13.1	13.1	13.1	13.6	15.2	12.6	13.6	10.2	13.3	10.6	11.6	11.6	12.7	
Imports GNFS, real growth	15.3	16.7	11.1	11.9	14.2	16.9	13.7	14.1	14.1	14.1	9.3	14.0	12.0	12.7	12.8	12.9	9.7	9.2	11.0	12.0	
Inflation, corresponding period of previous year = 100	2.4	6.4	6.7	6.8	4.7*	4.7	6.1*	6.1	6.1	6.1	3.4	3.8	3.7	4.4	2.8	3.0	3.2	3.6	3.3	3.7	
Inflation e.o.p.	5.7				4.0*		4.0*	4.0	4.0	4.0											3.4
Inflation, previous year = 100	2.4	5.9	5.7	5.7	7.3*	7.3	6.1*	6.1	6.1	6.1	3.1	3.6	3.3	3.9	2.4	2.6	4.3	4.7	3.3	3.7	
Core inflation, corresponding period of previous year = 100	-0.1	4.9	5.0	5.6	2.7*	2.7	4.6*	4.6	4.6	4.6	2.0	2.2	3.2	3.5	2.9	3.1	3.4	3.6	2.9	3.1	
Administrative prices, corresponding period of previous year = 100	9.5	11.0	12.0	10.4	10.8*	10.8	11.0*	11.0	11.0	11.0	7.2	8.7	5.1	6.9	2.4	3.2	2.6	3.9	4.3	5.6	
Current account balance	-1 630	-499	-462	402	-920	-887	-1 476	-1 447	-1 447	-1 447	-438	-594	-483	-482	294	468	-940	-1 021	-1 566	-1 628	
Current account balance, % to GDP	-9.2	-12.2	-10.3	7.4	-17.3	-16.5	-7.6	-7.4	-7.4	-7.4	-9.7	-13.1	-9.8	-9.9	5.0	7.9	-16.3	-17.9	-7.4	-7.7	
Exports, mln. EURO	6 668	1 719	1 899	2 189	2 126	2 187	7 933	7 994	7 994	7 994	1 985	2 101	2 123	2 242	2 360	2 504	2 277	2 484	8 746	9 330	
Imports, mln. EURO	8 868	2 228	2 691	2 648	3 105	3 145	10 671	10 712	10 712	10 712	2 525	2 681	2 992	3 148	2 955	3 072	3 263	3 583	11 736	12 484	
M3, p.a.	14 766	16 754	17 457	18 561	19 289*	19 289	17 945*	18 015	18 015	18 015	21 361	20 798	22 100	21 987	23 590	22 413	24 704	23 095	22 939	22 073	
Reserve money, p.a.	4 421	4 843	5 007	5 481	6 034*	6 034	5 341*	5 341	5 341	5 341	6 134	6 442	6 343	6 663	6 944	6 711	7 645	7 106	6 767	6 730	
Tax revenues	11 114.1	2 933.5	3 152.0	3 159.9	3 444.4	3 528.7	12 689.7	12 774.0	12 774.0	12 774.0	3 129.9	3 366.5	3 351.6	3 364.5	3 321.4	3 352.4	3 722.4	3 759.6	13 523.3	13 843.0	
Total revenues	14 069.7	3 640.1	4 009.1	3 972.1	4 216.8	4 233.3	15 838.0	15 854.6	15 854.6	15 854.6	3 799.5	4 079.3	4 224.0	4 174.1	4 053.7	4 203.8	4 599.7	4 542.3	16 676.9	16 999.5	
Unemployment rate	13.7	13.3	12.0	11.0	11.6	11.8	12.0	12.0	12.0	12.0	12.3	12.4	11.3	11.4	10.5	10.5	11.0	11.3	11.3	11.4	
Participation rate	49.2	48.1	50.5	50.8	49.3	49.4	49.7	49.7	49.7	49.7	48.8	48.8	51.3	51.1	51.7	51.6	50.2	50.0	50.5	50.4	

* reported data

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