THE BULGARIAN ECONOMY: ANALYSIS AND OUTLOOK

growth report

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AGENCY FOR
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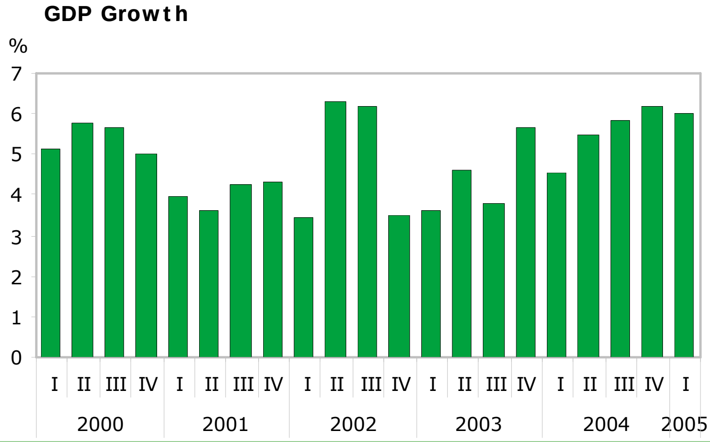
List of Abbreviations:

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

Performance of the Bulgarian Economy since the Start of 2005

In early 2005 the Bulgarian economy went on performing at a rather fast rate. Q1 GDP stepped up by 6% in real terms and amounted to BGN 8.7 billion in nominal terms while hitting a six-year Q1 record high in volume terms and providing a solid ground for an annual growth of over 5%.



Source: NSI

The manufacturing industries were the most robustly performing sector in the first quarter of 2005, reporting a gross value added rise of 8.2%. All manufacturing industries, but mining and extraction and electricity, heating and water generation and supply, outstripped growth in the economy. At the same time, construction reported the most significant increase in both value added and gross output of 14.2 and 26.4% respectively. In 2004 GVA in the construction sector outstripped gross output growth, implying that most entrepreneurs were passing the rise in raw material prices onto end-users rather successfully. However, the sector made a steady shift from the market of producers to a market of consumers, as the rise in real estate prices slowed down and raw material prices went on the increase.

The processing industries posted a 9.7% rise in GVA and due to their relatively large relative share made the most significant contribution to growth in the sector. Moreover, this is the sector facing the strongest impact of foreign competition and hence affected in the utmost by the terms of trade. Therefore, it was the favourable market situation worldwide in the first quarter that boosted the performance of the processing industries. Metallurgy was again the major contributor to sales growth, with the share of ferrous metallurgy going down at the expense of non-ferrous metallurgy. Q2 copper prices held steadily higher compared to 2004. The quotations on the London Metal Exchange fluctuated between USD 3100 and 3650 per ton, going well above this as of end-June. All this, coupled with the stronger USD to the EUR, provided powerful incentives to the local producers.

The strong reliability of the Bulgarian processing industries has put some of them at risk, and textiles and clothing reported a year-on-year decrease as early as the first quarter due mostly to the removal of the quotas for Chinese exports. Furthermore, as Eurofer statistics pointed, the iron scrap index has gone on the decrease since late 2004, indicating a major shrinkage in global steel demand. This was further evidenced by the news of a planned 20% reduction in production at Kremikovtsi Steel Works due to the market stagnation worldwide, which may have a harmful effect on the performance of ferrous metallurgy in the second half of the year.

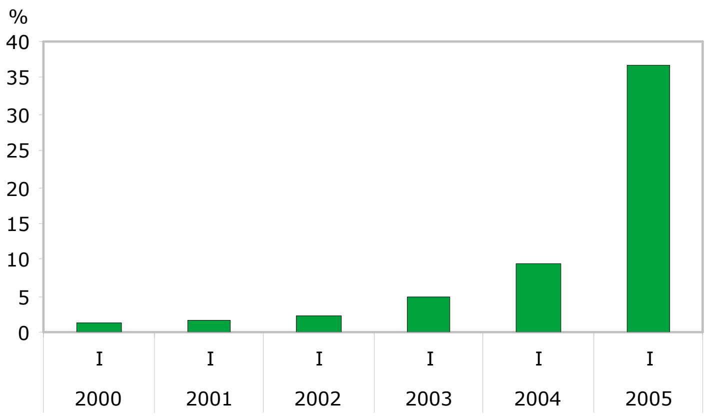
GVA in electricity, heating and water generation and supply stepped up by 3.2%. This was the first quarter in the last two years in which the industry reported some growth in the indicator and made a positive contribution to the sectors GVA. However, as information on the state-of-affairs in the companies is limited, it is difficult to say how much of this growth was due to the restructuring exercise underway and how much of it was due to other reasons.

Mining and extraction was the only industry posting a GVA decline (4.2%) for the first time since the first quarter of 2002, indicating that it may have well passed a peak in its performance. Gross value added, gross output and the sectors deflators all stepped down, suggesting decreased demand.

The service sector grew by 7.4% in real terms, with all industries reporting a positive contribution to growth. Trade posted the most significant rise of 16.7%, trade in non-food items in particular due to the increased consumption in the country. Growth in finance and transport ran relatively high. In addition, the financial sector performed rather vigorously due to boosted lending and led to improved bank efficiency.

At the same time, the agricultural sector reported a decline in both gross output and value added due most probably to the problems faced by livestock production. In 2004 it decreased by 1.5% and in the first quarter of 2005 farm-gate prices went on the increase as local producers were unable to meet the growing domestic demand. All this resulted in a 20% year-on-year rise in meat imports. Furthermore, a turnaround in the above trend is unlikely to take place in the short run due mainly to the specificity of the production technologies in place and shrinkage in the animal numbers despite the improved sector s productivity.

Credits Flow / Domestic Demand



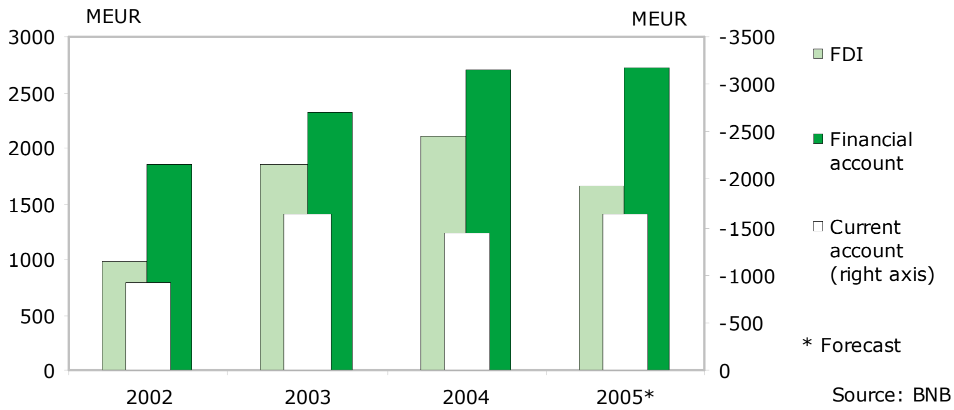
Source: NSI, BNB

Stepping up by 7.5%, domestic demand proved to be the main engine of growth in the economy. Final household consumer spending made a 5.6 percentage point contribution to GDP growth. This was, however, a much expected development due to the robust lending of commercial banks in early 2005, March in particular. In the first quarter, the share of loan resources in domestic demand financing stepped up significantly. The ratio of net loan extensions to domestic demand posted a four-fold rise and loan resources now financed some 40% of domestic demand. In addition, the high growth in private consumption was due to the higher countrys employment and real wages. Public consumption also stepped up (5.8%) and made a one percentage point contribution to GDP growth.

Q1 investments registered a 9.2% real-term increase, making a 1.8 percentage point contribution to GDP. The slowdown in investment growth was not accidental as it fully matched the expectations for a duller investment activity according to the NSI survey of November. The moderate rise was coupled by a decreasing share of national savings in investments, e.g. national savings in the first quarter financed some 29% of investments vs. 43% on a year earlier. The reasons for this were as followed: on the one hand, the high consumption growth re-channelled vast amounts of money to consumer spending. On the other, there was a certain flight of income through the balance of payments, given an ever- declining level of net current transfers. All this, by and large, offset the effect of the financial inflows, leading, therefore, to more or less the same share of national and domestic savings in GDP of 6.5 and 6% respectively. As a result, the share of foreign investment financing went up to about 70%.

As a rule, the first-quarter contribution of the external sector ran at 2.6 percentage points. Nevertheless, foreign demand rose by 8.8% in real terms. At the same time, the vigorous performance of the Bulgarian economy resulted in a higher countrys foreign trade turnover. According to balance of payments statistics, export growth in the four months to May outstripped imports (21.8% vs. 21.3%). However, the higher value of imports resulted in MEUR 931 worth of a trade deficit, deteriorating by MEUR 154.3 on a year earlier. More specifically, it was the energy price dynamics which accounted for about one-third of the deterioration reported. Energy imports stepped up by 38% on an annual basis whereas energy prices in EUR soared by 40.8%.

Financial account, FDI and current account



Source: BNB

In the four months to May, investment goods imports posted a most healthy gain of MEUR 287.1, or 34.6%, followed by consumer imports (14.6% up relative to the Jan-Apr04 period), both sustaining a steady upward trend. Automobile imports enjoyed again the largest share in the above rise, with the altered methodology of valuation producing little, if any, effect at all after February. Raw material imports went up by some MEUR 138.7, boosted mostly by the high prices of ferrous and non-ferrous metals as well as the strong demand for raw materials on the part of the export-oriented industries. Plastic and rubber imports have also gone on the increase since the start of the year.

As in 2004, the robust foreign demand for metals promoted further the vigorous countrys export performance in early 2005. Raw material exports ran some MEUR 303.3 up on a year earlier due mainly to the iron, steel, upstream food and chemical industries. Having followed a sustainable upward trend over the past couple of years, investment goods imports now picked up further speed at 34.7% on a 12-month basis, accounting for 15.3% of total exports. In addition, the higher exportation of machinery, vehicles and equipment, all of them products of high value added, was indicative of the stepwise gearing of the economy from the labour-intensive up to the high-tech industries. At the same time, the weight of the largest export item, i.e. footwear and clothes, declined to 17.9%, with exports going down by 1.3% on a year earlier. However, it is still too early to say what the effect of the strong competitive pressure of Chinese imports on the EU market is, as an in-depth analysis of the state of affairs in the most robustly performing export-led industry will be made available as late as the end of the usually strong third quarter.

The BGNs peg to the single European currency and countrys integration in the EU markets have made Bulgarian exporters turn to the European region, which made the most significant contribution in the countrys export growth. A most notable rise was reported by cast iron, iron and steel exports to Italy and Germany, non-ferrous metal exports to Belgium and electricity to Greece. As in 2004, around 80% of the Bulgarian exports were destined to the EU (25) and the Balkan countries, and only 4% to the USA, a bare 1.3% to Russia and about 6% to Asia. As already pointed out, anticipated as it may have been with a view to Bulgarias accession to the EU, it has also made the local economy heavily dependent on the market situation in Europe.

Throughout 2004 revenues from services and current transfers were steadily growing in importance in covering partially the trade deficit. However, early 2005 witnessed a turnaround in the above trend, and if net services ran again negative at MEUR 124.2 due mostly to net transport expenditures, net revenue from current transfers reported an unexpected decrease of 9.3% down to MEUR 232.2. Private transfers stepped up as anticipated to MEUR 266.5, whereas EU pre-ins amounted to MEUR 23.3, going some MEUR 20.5 down. Furthermore, payments on current transfers went on the increase. The income balance ran negative at MEUR 159.9. Relative to the Jan-Apr04 period, income from portfolio investments stepped up as did payments having to do with reinvested profit and dividends.

The financial account in the four months to May ran positive at MEUR 1031.4. FDI totalled MEUR 334.6, or MEUR 67.8 down on a year earlier, with some MEUR 46 being due to last years privatisation. The ***other investment-liabilities*** item stepped up by MEUR 1272.9, with the deposits of non-residents going up by MEUR 502.4 while declining by MEUR 207.1 in the last reported month. The above development was triggered by the robust lending activity of the commercial banks prompted by the BNB measures announced. Some other liabilities, which according to the methodology of the Central Bank account for transactions on items not covered elsewhere as well as debt in arrear, increased by MEUR 597.9.

In the four months to May the overall balance ran positive at MEUR 46.9, with the FX reserves of the Central Bank rising by MEUR 5.5. In addition, the effect of the MEUR 714.7 worth of buyback of IABs was gradually offset.

The interrelation of bank lending, higher consumption and the huge trade deficit has been one of the most debatable issues on the economic policy agenda in the last couple of years. In 2004 BNB undertook a series of measures aimed at curtailing credit growth but they had little, if any, effect at all. In early 2005, however, the Central Bank took further action in an attempt to put the brakes on the rampant credit growth by requiring commercial banks to maintain additional minimum required reserves, have they not complied with certain growth restrictions. The measures were also prompted by a major concern having to do with the quality of bank portfolios. Commercial banks responded by lending larger amounts of money, especially in the last week of March, aiming at increasing the credit base[1], used to estimate the credit growth rate when setting the additional minimum required reserves. In March alone, bank credit portfolios stepped up by 24.1% or BGN 3.37 billion (vs. BGN 4.33 billion throughout 2004). Moreover, the month saw a most robust growth in the time and demand deposits of non-financial institutions and other customers (BGN 2.21 billion) and the time deposits of banks (BGN 1.3 billion), the bulk of which were attracted from abroad[2]. The above growth was due to fresh loan extensions to creditworthy corporate customers and the deposit of the resources lent on banks accounts as security and for follow-up credit repayments. Another way of increasing bank credit portfolios had to do with the transfer of credit to the mother banks abroad. As a result, the outflows in the form of loans transferred amounted to BGN 186.3 million (vs. BGN 8.7 million in the same month of 2004).

The fact that end-of-Q3 credit extensions were mostly fictitious in nature was further evidenced by the credit portfolio dynamics in the following two months. Loan extensions plunged by 9.5% or BGN 1.65 billion in April, remaining almost unchanged in May (0.1% or BGN 21.7 million down). The deposits taken followed the same pattern of dynamics.

The attempts of the commercial banks to bypass BNB measures and the enormous credit growth reported forced the Central Bank to initiate certain amendments to the credit growth base and penalize aggressive lending. Commercial banks, which posted a credit growth rate of over 4% in March, were now required to use as a basis not the size of their credit portfolio as of the end of the first quarter but the end of February, increased by four per cent. In addition, BNB made some alterations to the credit growth restrictions, which if circumvented, the commercial banks shall cover by depositing additional minimum required reserves[3]. Therefore, to maintain and uphold financial stability and curtail the ever-growing current account deficit, the Central Bank has used again the only monetary policy instrument in hand under the currency board arrangement.

As a result of their aggressive lending practices, commercial banks posted significant net gains (18.7% up as of May05 on a 12-month basis), bringing about a most robust

[1] Under BNB Regulation №21 laying down minimum reserve requirements total credit growth shall be reported as at 31 March 2005.
[2] In March there was reported in the balance of payments some BGN 1020.5 million worth of financial inflows in the form of deposits of non-residents with local banks.
[3] Three-month credit growth shall not run higher than 5% and hence 12.5, 17.5 and 23% on a six, nine and twelve-month basis.

increase in the sectors GVA. The bulk of profit reported was due to net interest income (a 33.5% year-on-year rise). At the same time, the amounts on operating costs and credit provisions went on the rise, especially those of the second bank group. As of end-May, the net credit provisions of the banks of the same group accounted for 293.7% of their operating profit vs. 48% for the whole banking system. It follows that their credit portfolios are likely to deteriorate resulting in a worsened capital adequacy, have they not raised their capital base.

The rampant credit growth of late March affected the interest rate dynamics as followed: the interest rate on short-term loans in EUR plummeted to 6.42% vs. 7.25% in February, as the bulk of March credit was short-term and extended in EUR to corporate customers (trade credit in EUR went up by 32% or BGN 1.9 billion). Interest on short-term BGN loans was steadily rising throughout the period surveyed but May, whereas interest on long-term BGN credit followed the opposite dynamics. The interest rate spread between time BGN deposits and short-tem loans in BGN advanced to 5.15 and 6.44% in March and April, but stepped down to 5.57% in May. The higher spread was due to the restrictive measures of the BNB, which, however, had as a rule a rather short-lived effect on the interest rate dynamics. The average weighted interest on interbank market placements went up to 2.11% vs. 1.92% in February.

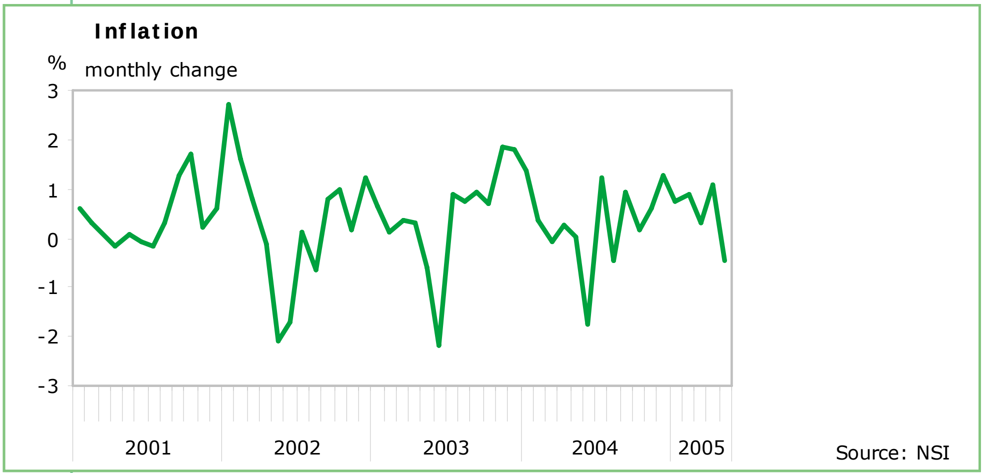
Early 2005 sustained the labour market upswing of the past couple of years. According to NSI labour force survey data, Q1 average employed numbers amounted at 2838.4 thousand or 55 thousand (2%) up on a year earlier due wholly to the robust job creation in the private sector. At the same time, Q1 jobless numbers decreased to 362.3 thousand or 66.5 down relative to the first quarter of 2004. The unemployment rate ran at 11.3%, reporting a 2 percentage point decline on a 12-month basis and holding steady at a historical low.

Q1 average wages stepped up by 9.5% in nominal terms and 5.5% real terms on a year earlier. Monthly NSI data on wages implied that wage growth was fostered by higher productivity[4] (5% up on a quarter earlier) rather than the minimum wage increment up to BGN 150 in force since the start of the year.

The country s macroeconomic stability has made a major contribution to growth in the economy in the last few years. In the five months to June05, consumer prices rose by 2.55%. At the same time, although inflation over the same period ran higher relative to

[4] Estimated as a ratio of GVA to LFS employment figures.

the past two years, it held steady at fairly low levels. However, the price level in the first half-year period of 2005 stepped up mostly due to the higher fuel and fixed telephone line prices. Since the start of the year, crude oil prices reported a most drastic increase, hitting a record high in March and June. All this sent March and April car fuel prices higher by 3.69 and 6.26% respectively. The contribution of the group to the higher consumer price inflation in the five months to June was estimated at 0.39 percentage points.



April saw some changes in the prices of fixed telephone lines as followed: subscription fees stepped up by 7.14%, whereas the aggregate increase in call rates amounted to 14.32%. Pricing also underwent some alterations now including a per-call charge and per-minute charging instead of the per-unit rates. In addition, the Bulgarian Telecom offered households new pre-paid call packages. However, as the latter were not taken into account in the 2004 consumer basket, the effect of the price change on the overall price index has been inaccurately reported. The contribution of the higher-priced fixed telephone lines in the January-May period ran at 0.18 percentage points. According to AEAF estimates, the April effect of price re-adjustment has been overstated and can therefore be expected that the price change will affect the structure of the consumer basket in 2005.

Free prices in the five months to June went up by 2.55%, making a 2 percentage point contribution to overall inflation. Administered prices also stepped up by 2.55%, posting a contribution of 0.54 percentage points. Furthermore, March and May witnessed a slight rise in tobacco prices, whereas in April the night-time electricity rates for consumption up to 50 kWh, applied in the winter heating season, were removed. As a result, electricity prices reported an aggregate increase of 0.99%.

The currency board remained stable and highly trusted by economic agents as a mainstay of the countrys economic development. Despite the payments on the foreign debt made, gross FX reserves carried on rising (y/y growth of 22% as of end-June 2005) due mainly to adequate management and the sizable financial inflows into the country and ran almost twice as high as reserve money (199.8% in end-May 2005 vs. 187.6% in end-2004).

March saw a record high growth in money supply of 11.9%, prompted by the rise in deposits of agreed maturity up to two years, followed by a most drastic drop in April (-5.2%). In May M3 increased by a regular 2% on a month earlier. Broad money rise resulted in a concurrent increase in net foreign and net domestic assets in the banking system. Net foreign assets stepped up, as triggered by the higher Central Bank s FX reserves while the net foreign assets of the commercial banks decreased significantly in March only to go on the upswing afterwards but falling short, however, of their end-of-February level.

Growth in net domestic assets was boosted solely by non-government sector credit, which was by and large influenced in the first quarter by the response of the commercial banks to BNB measures. After March, however, loans to non-financial enterprises took up a downward trend, whereas household credit went on the increase. It is not clear yet if the above drop is a temporary development that will fade away as banks gear themselves up to the altered terms of lending and statutory amendments to supervision or corporate credit will be altogether outweighed by consumer and mortgage loans. Expected as it may be, another possibility may have a rather adverse effect if banks no longer extend investment loans. Government-sector credit declined as a result of the high tax revenue at that time of the year.

2005 sustained the upward trend of the capital market of the past couple of years. Despite the price corrections of almost all companies in the second quarter, trading remained brisk and posted a most robust six-fold rise in volumes on a year earlier. SOFIX stepped down in end-February, reporting the longest correction since early 2002 due to:

- a remarkable growth in market capitalization, followed by the usual price corrections;
- re-channelling fresh capital to the stock exchange in the wake of BTC privatization, boosting the demand for shares and the fast growth of the indices. What followed was a continuous decline as most market players sought ways to make a profit overnight;
- the perception of most market players that the bulk of companies traded on the Bulgarian Stock Exchange were overstated, at least against the key indicators of performance. However, when both the short- and mid-term trends are up, such attitudes may be somewhat reconciled, but they will come to the fore again at the first sign of imminent corrections;
- growing political risk having to do with the July parliamentary elections and likely amendments to the institutional framework of the capital markets ever afterwards.All this added up to the above factors while checking any rebound of the upward trend.

Despite the drop of the last couple of months, the long-term upward trend is to persist, given the current institutional framework and performance of the economy (GDP and investment growth, accession to the EU), and triggered by the very capital market mechanisms. As it is practically impossible for market players to sell short, the only option available to make a profit is when prices are up. Therefore, whenever there is a drop, market players are only allowed to make the most of the following marketing strategies: either sell and make capital gains, and then start bidding at lower prices; or hold the shares in the hope that prices will go up again after the correction, i.e. there is a great amount of uncertainty as to how long the correction may take and also a likelihood to sell when shares are at rock bottom and then bid at higher prices. The following months are expected to witness a turnaround in the trend, as the share prices of most companies run closer to the estimates made on the basis of key factors. This, however, may not trigger any further rise in prices, but it is a strong stimulus for overcoming the downward trend underway.

Another factor behind the countrys macroeconomic stability had to do with the robust performance of the budget. As of end-May (periods cumulative), the budget surplus amounted to BGN 994.8 million, with some one-third of it being generated in the last month. It accounted for 2.4% of the 2005 GDP expected (BGN 41077.4 million). The huge surplus was mainly due to the conservative approach to revenue planning. A certain amount of cautiousness is indispensable to the budget formation process, but any excessive conservatism may well be treated as inadequate planning and poor transparency of the formulation exercise.

The cash balance ran positive due mostly to the over-performance of revenues, which in the five months to June stepped up by 16.4% (15.3% on a consolidated basis) on a year earlier. Tax revenue growth was fostered by the vigorous revenue from VAT related to the higher imports in the same period. Import growth, in turn, led to higher revenue amounts from customs duties, the performance of which as of end-May accounted for 59% of the budget act projections. Despite the reduced rate in force since the start of the year, profit tax revenues ran some 13.3% up relative to the January-May04 period due to the higher compensation payment made in March. As for the other direct tax item, i.e. the income tax, the combined effect of the higher tax base and rate cut-down led to a rather negligible increase in revenues (4.1% on a year earlier). Revenues from social insurance contributions also stepped up as a result of the higher countrys employment, minimum wages and social insurance thresholds.

Government spending went up by 10.1% on a year earlier due mainly to the rising expenditures on subsidies and investments. The 13.6% year-on-year rise in subsidies was due to the April payment of the lump sum allocated to the Tobacco Fund. Capital expenditures increased too in line with the 2005 investment policy guidelines. As for the other expenditure items, there were reported no significant changes on a year earlier. At the end of June, the government made an official statement as to its intentions to exercise its call option to FLIRBs ahead of schedule (28 July). The buyback is to result into some USD 600 million worth of a decrease in the government debt. ❑

Forecasts by the end of 2005

External Assumptions

Q3 crude oil prices fell short of AEAF expectations. Following the peak in March and April, oil prices stepped down only to go on another upswing in mid-May due to the unstable situation in the Middle East. The price increase was triggered not only by underlying economic factors at work but market speculations as well. As a result of the growing oil demand worldwide, the chances of producers to respond to short-term shocks remain rather slim. As such shocks are inevitable and hard to predict, the reduced possibilities of producers to increase production leads to market turmoil and hence higher prices. In the short run, oil demand remains inelastic as to prices and higher prices are therefore not expected to bring about a decrease in demand. The current estimates do not provide for an oil price drop by the end of the year. As a result, average spot prices are to amount to some USD 50-51 per barrel on a quarterly basis, which corresponds to an increase of slightly less than USD 4 per barrel vis-a-vis earlier estimates.

Current forecasts draw upon a smooth increase in the LIBOR in USD, retaining some earlier assumptions. The Federal Reserve will carry on raising the US interest in an attempt to reduce the inflationary expectations in the economy. At present, there are no indications as to any slowdown, as Q3 growth in the US economy amounted at 3.7%. At the same time, Q1 growth in the Euro area was estimated at 0.9%, running lower than earlier assumptions. On the other hand, the growth projections for the other three quarters have not been revised, but this has to be viewed in the context of the lowered interest rates in the area by the ECB. Such a decrease may boost the economy while resulting in a larger interest rate difference between the USD and the single European currency. This in turn will exert a strong downward pressure on the EUR, which together with the rising crude oil prices may lead to an inflation rate well above the ECB target.

The end of the second quarter saw a turnaround in the USDs downward trend, triggered by the lower confidence in the single European currency having to do with the rejection of the European Constitution at the referendums held in France and the Netherlands as well as some official statements that Italy may abandon the Euro-area. The BGN/USD exchange rate stepped up by BGN 0.04 on average on a quarterly basis, calling for certain revisions in the Q3 and Q4 expectations. However, the upward trend in the USD to the EUR is not anticipated to be further sustained. Until recently the USDs appreciation has been explained by way of the broader interest rate difference between the US currency and the EUR as well as the weak Euro-area growth. But as data are released with a certain lag in time, the effect of the stronger USD on the US trade balance has not been examined yet. Most probably, the effect will be negative, sending the USD on the downswing again. What is more, the net effect of the above developments may result in a further depreciation of the US currency. As a result, current estimates are based on a slight appreciation of the EUR in the second half-year period vis-a-vis the present levels.

Current Forecasts for the Performance of the Bulgarian Economy in 2005 and Likely Revisions vis-a-vis Earlier Estimates

Current forecasts retain the anticipations for 2005 GDP growth of 5.2%. The high Q1 growth lived up to expectations and therefore it is not necessary to revise annual GDP growth estimates. However, the structure of GDP needs some readjustments vis-a-vis earlier projections.

In the first quarter, the import and export deflators stepped up at the expense of real growth due to the increased international prices. Current forecasts sustain the above upward trend, but despite the nominal-term rise in both imports and exports, their real growth has been revised downwards relative to the previous projections.

The previous estimates relied on a robust growth in consumption while understating the effect of boosted bank lending in end-March, prompted by the tougher BNB measures. The household budget data of April give solid grounds to assume that the high consumption of non-food items, communications and non-factor services will go up even higher in the second quarter, which is why AEAF forecasts for the April-June05 period have been revised upwards. At the same time, the strong first half-year consumption may reduce the indicators growth potential in the second half even further, if commercial banks limit consumer credit. As a result, Q3 and Q4 consumption forecasts have been revised downwards. On a 12-month basis, growth in consumption is expected to run some 0.4 percentage points higher on a year earlier at 5.1%.

Q2 GDP growth forecasts are not to undergo significant changes and will remain at about 4.9%. The revisions, having to do with the altered contribution of net exports will be made up for by the change in the contribution of consumption within total growth. Q2 investments are not to be revised and expected to rise by 8% in real-terms. On the basis of the April sales and output indices, Q2 change in inventories is expected to run slightly above BGN 200 million in nominal terms, or close to the level in the same quarter on a year earlier. Inventory change will have a negligible contribution to total investment growth. Gross fixed capital formation is to go up by about 12% in the second quarter. Twelve-month investment growth is expected to amount to around 8%, holding steady at the level foreseen in the previous estimates.

2005 government consumption estimates are by and large dependent on the budget balance. The budget is expected to run a surplus, accounting for 1% of GDP, in line with the IMF arrangements. The performance of revenues as of the present date suggests that the generation of an even higher surplus is also feasible, but currently there are no indications as to a new target level of the budget balance along the lines of tougher fiscal policies. Besides, there is a certain amount of uncertainty having to do a possible decision of the new government about the allocation of the extra budget revenues. However, current estimates do not draw upon a likely change in the budget balance. Growth in government consumption is to run higher on a year earlier and be mostly focused, as usual, in the last quarter when pay and pension bonuses are paid and outstanding government payments met. Growth in consumption will result in higher spending on maintenance costs and wage bills.

Budget revenues forecasts have, too, been revised upwards, with the most significant changes affecting tax revenues having to do with imports and exports, i.e. VAT and customs duties. As nominal-term import growth is expected to slow down only insignificantly in the second half-year period of 2005, the January-May revenue amounts from VAT and customs duties will be further sustained. The above estimates also take account of the soaring oil prices, coupled with the strong USD to the EUR, which will in turn lead to higher VAT revenues from oil imports. Revenues from excise duties by the end of the year are not expected to rise vigorously as the robust Q1 growth was prompted by one-time imports of oil for stock replenishing. The same applies to corporate tax revenues, which stepped up most significantly in the first quarter due to the higher tax compensation payments. The rate cut-down (4 points) since the start of the year will produce an adverse effect on tax revenues, sending them on a 12-month downswing. The performance of revenues from personal income and social insurance contributions in the five months to June gives no grounds for any forecast revisions by the end of 2005.

Free price inflation is anticipated to go up by 3.67% relative to December04. The contribution of fuel prices to the countrys inflation is estimated at 0.53 percentage points, running higher than April estimates due mainly to the unfavourable oil price developments in the international markets. On an annual basis, however, fuel prices will be up by 10.05%. Market service prices are to rise by 6.93%, posting a 1.36 contribution to inflation. The sharp increase in the group was spurred by the price adjustments in telephone services of April. The year-on-year rise in food prices is expected to run at 2.29%. However, there is a certain amount of uncertainty in forecasting food price change since it is heavily dependent on the weather conditions and crop yields. The contribution of free prices to overall inflation is to amount to some 2.89 percentage points.

Administered price increase will be around 3.37%, running considerably lower compared to the preceding years. Its contribution to inflation is estimated at 0.72 percentage points.

Overall inflation is to amount to 3.60% as of end- 2005 and 3.96% on a years average.

According to AEAF estimates, the labour market upswing will persist well into the second half-year period. The unemployment rate will carry on declining, at a slower rate though, due to the narrowed scope of the employment promotion programmes. 2005 unemployment[5] is to amount to 10.6% on an annual average, or some 0.8 percentage points down vis-a-vis earlier forecasts. Furthermore, employment throughout 2005 is to advance by 1.9%[6]. The employed numbers will step up as a result of the boosted business activity in the private sector, as the narrowed scope of the active labour market measures may limit job opportunities in the economy. Productivity is to increase by about 3% on an annual basis, running close the 2005 real wage growth forecast of 3.2%.

Sustainable private-sector employment will lead to a higher participation rate (0.1 percentage point up on a 12-month basis to 49.8%[7]7). The rate will be further fostered by the lower discouraged numbers, as some part of them are expected to join the labour force cohorts.

Current forecasts point to a 2005 current account deficit of 8.5% of GDP, worsening by 0.8 percentage points vis-a-vis earlier estimates. The difference stems mainly from the enormous countrys trade deficit, which is to go up as high as 15.6% of GDP. In

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5 By definition of ILO.
6 Based on labour force survey data.
7 Of people at the age of 15 and above.

addition, the above revisions were triggered by the latest foreign trade statistics in the first four months of the year as well as some assumptions as to a certain rise in the USD prices of energy and metal goods worldwide and a stronger USD to the single European currency. As a result, both export and import growth is to amount to about 20% in nominal terms. Foreign demand will remain strong throughout the year, and exports will grow by 10.8% in real terms, whereas the deflator is to reach 8.2%. Relative to earlier projections, real growth will run lower while the deflator is to increase two fold.

Import growth will be mainly pre-determined by robust exports, consumption and investment in the year. The vigorous performance of consumer goods imports is to be further sustained. The re-vamp of the companies already privatised and FDI inflows will promote investment goods imports, whereas the recently discerned decline in corporate lending will produce the reverse effect. The soaring crude oil prices are to be one of the key factors making imports more expensive. Therefore, drawing upon the above assumptions, imports are to step up by over 10.6%, and the deflator to run at about 8.6%, or slightly above exports.

Current forecasts suggest that net services will go on covering some 30% of the trade deficit. Revenue from tourism is to increase by about 20% on a year earlier, reporting a year-on-year rise of some 18%.

Receipts from current transfers over the past few years have turned out to be a major current account item, both curtailing the current account deficit and promoting consumption, of imported goods including. The inflow of private transfers, made mostly by Bulgarians working abroad, will go on rising by about 18% in the second half-year period. On the other hand, forecasts provide for over MEUR 200 of absorption of the EU pre-ins, but this is a rather optimistic scenario against the developments taking place since the start of the year. Therefore, net current transfers are expected to cover some 30% of the trade deficit, given the current expectations.

The income balance will be the main reason behind the worsening current account due mainly to the increasing foreign ownership in the country and related thereto higher payments on intra-firm debt interest and dividends to foreign owners.

FDI are expected to total MEUR 1652.3, with estimates remaining unchanged. Due to its enormous size, net FDI may fail to make up fully for the current account deficit for the first time in the last three years. Revenues from privatization are to amount to MEUR 227, taking account of the sale of some of the district electricity supply companies as well.

Despite the expected rise in the US interest rates in 2005, the cash inflows on the financial account are to be further sustained, given the current interest rate spread and high return of loan resources in BGN. At the same time, the Central Banks constraints on the countrys rampant credit growth may influence external financing of commercial banks, and compel, on the other hand, the non-financial sector to borrow from abroad. However, any estimates as to the second half-year period are difficult to make, as banks followed a rather untypical pattern of behaviour in the first quarter. And yet, the expectations are that the cash flows on the financial account will cover fully the current account deficit even in the event of another ahead-of-schedule buyback of Bradies worth USD 607.64 million. At the same time, the inflows are to ensure additional resources for imports, and a likely decrease in the amounts may lead to a lower current account deficit.

In theory, the current account deficit forecast (8.5% of GDP) runs rather high. Bulgaria is a small, open and dynamically performing economy, reporting robust GDP growth and solid potential. At the same time, its strong economic and political bias to the EU values implies a high amount of certainty and upbeat expectations on the part of both local and foreign economic agents. All this considered, the boosted foreign economic activity and hence huge current account deficit are normal developments, which should not give rise to any macroeconomic fears as long as they do not exert a downward pressure on BNBs reserves and domestic savings. End-of-year FX reserves of the Central Banks are to step up significantly, despite the foreign debt buyback. At the same time, any continuous retention at about 7-9% of GDP should be as carefully supervised and controlled as possible under a currency board arrangement.

The expectations for a slightly higher money supply growth on a year earlier are to be further kept, with forecasts amounting to about 24%. At the same time, December05 M3 growth is to lag behind the usual end-of-year rise.

The money multiplier will go on the downswing by the end of the year due mostly to the increase in bank reserves (hence monetary base) to take place in early August when the additional minimum reserve requirements are to be met. The multiplier is to average 3 throughout the year, posting a negative contribution to money supply growth on an annual basis.

The interest rate increase at the end of the first half-half year period is to persist into the third quarter as well, while any decrease is to occur as late as the end of the year. In any case, interest rates are highly unlikely to go well below the current levels while holding steady at them or slightly below. At the same time, deposit interest will be heavily dependent on bank lending policies upon meeting the additional minimum reserve requirements. The interest rate spread between short-term loans and time deposits is to slightly advance to 5 and 6 percentage points.

Relative to the first half-year period, credit growth in the six months to December is to slow down due mainly to the supposedly lower corporate lending. Consumer and mortgage loans are expected to sustain the current rates, with 2005 growth running around or slightly above 40%, provided bank lending policies comply with the BNB credit growth restrictions or unless commercial banks have deposited additional reserves and kept the countrys credit expansion going. ❑

Macroeconomic Indicators 2003 - 2005

		Reported data						Forecast									
		2003	Q1 2004	Q2 2004	Q3 2004	Q4 2004	2004	Q1 2005		Q2 2005		Q3 2005		Q4 2005		2005	
								forecast	reported data	previous	revised	previous	revised	previous	revised	previous	revised
Exchange rate USD/BGN, p.a.		1.7	1.56	1.62	1.60	1.51	1.57	1.49	1.49	1.52	1.55	1.54	1.60	1.55	1.59	1.53	1.56
Petroleum spot price (APSP)		28.9	32.1	35.6	40.6	42.8	37.8	46.2	46.2	47.5	50.8	47.3	51.0	46.3	50.0	46.8	49.5
EU Area Real GDP growth	%	0.5	1.4	2.1	1.8	1.6	1.7	1.4	0.9	1.5	1.5	1.8	1.8	2.1	2.1	1.7	1.6
LIBOR U.S. dollar deposits	%	1.2	1.2	1.6	2.0	2.6	1.9	3.2	3.2	3.5	3.5	3.8	3.8	4.1	4.1	3.6	3.6
GDP, current prices	mln BGN	34 547	8 004	8 807	10 685	10 512	38 008	8 889	8 690	9 530	9 584	11 590	11 580	11 172	11 223	41 182	41 077
GNP, current prices	mln BGN	33 439	7 737	8 700	10 499	10 407	37 342	8 483	8 402	9 321	9 388	11 425	11 410	11 004	11 049	40 234	40 249
GDP, real growth	%	4.5	4.5	5.5	5.8	6.2	5.6	5.9	6.0	4.8	4.9	5.6	5.3	4.3	4.7	5.2	5.2
Consumption, real growth	%	6.6	5.3	4.3	3.7	6.6	5.0	5.4	7.3	4.5	5.0	4.3	4.0	4.6	4.6	4.7	5.1
Investment, real growth	%	18.2	38.0	15.0	8.0	8.2	14.8	9.5	8.5	7.9	8.0	8.2	9.0	7.0	7.1	8.0	8.0
Exports GNFS, real growth	%	8.0	7.0	10.6	14.1	19.8	13.1	15.2	8.8	13.6	11.5	13.3	12.2	9.0	10.0	12.7	10.8
Imports GNFS, real growth	%	15.3	16.7	11.1	11.9	16.9	14.1	14.0	10.8	12.7	11.6	12.9	12.4	9.2	9.1	12.0	10.9
Inflation e.o.p.	%	5.6	1.7	0.2	1.9	4.0	4.0	1.9	2.0	0.7	1.2	1.1	1.3	3.4	3.6	3.4	3.6
Inflation, corresponding period of previous year = 100	%	2.3	5.9	5.7	5.7	7.3	6.2	3.6	3.6	3.9	4.4	2.6	2.9	4.7	5.0	3.7	4.0
Core inflation, corresponding period of previous year = 100	%	-0.1	4.9	5.0	5.6	2.7	4.6	2.2	2.2	3.5	3.9	3.1	3.5	3.6	4.0	3.1	3.4
Administrative prices, corresponding period of previous year = 100	%	9.5	11.0	12.0	10.4	10.8	11.0	8.7	8.7	6.9	7.7	3.2	3.2	3.9	3.6	5.6	5.8
Current account balance	MEURO	-1 630	-499	-462	402	-887	-1 447	-594	-704	-482	-518	468	449	-1 021	-1 009	-1 628	-1 782
Current account balance, % to GDP		-9.2	-12.2	-10.3	7.4	-16.5	-7.4	-13.1	-15.8	-9.9	-10.6	7.9	7.6	-17.9	-17.6	-7.7	-8.5
Exports	MEURO	6 668	1 719	1 899	2 189	2 187	7 994	2 101	2 078	2 242	2 322	2 504	2 585	2 484	2 599	9 330	9 583
Imports	MEURO	8 868	2 228	2 691	2 648	3 145	10 712	2 681	2 729	3 148	3 263	3 072	3 169	3 583	3 700	12 484	12 861
M3, p.a.	mln BGN	14 723	16 688	17 584	18 491	19 367	18 033		21 488		22 429		23 457		24 530		22 976
Reserve money, p.a.	mln BGN	4 406	4 822	5 075	5 724	6 400	5 505		6 622								
Total revenues	mln BGN	14 070	3 640	4 009	3 972	4 233	15 855	4 079	4 167	4 174	4 616	4 204	4 398	4 542	4 773	16 999	17 954
Tax revenues	mln BGN	11 114	2 933	3 152	3 160	3 529	12 774	3 366	3 404	3 365	3 528	3 352	3 560	3 760	4 010	13 843	14 502
Unemployment rate	%	13.7	13.3	12.0	11.0	11.8	12.0	12.4	11.3	11.4	10.6	10.5	9.8	11.3	10.5	11.4	10.6
Particiption rate	%	49.2	48.1	50.5	50.8	49.4	49.7	48.8	48.0	51.1	50.6	51.6	51.2	50.0	49.5	50.4	49.8

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