THE BULGARIAN ECONOMY: ANALYSIS AND OUTLOOK

growth report

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

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

Translated by: Albena Toneva

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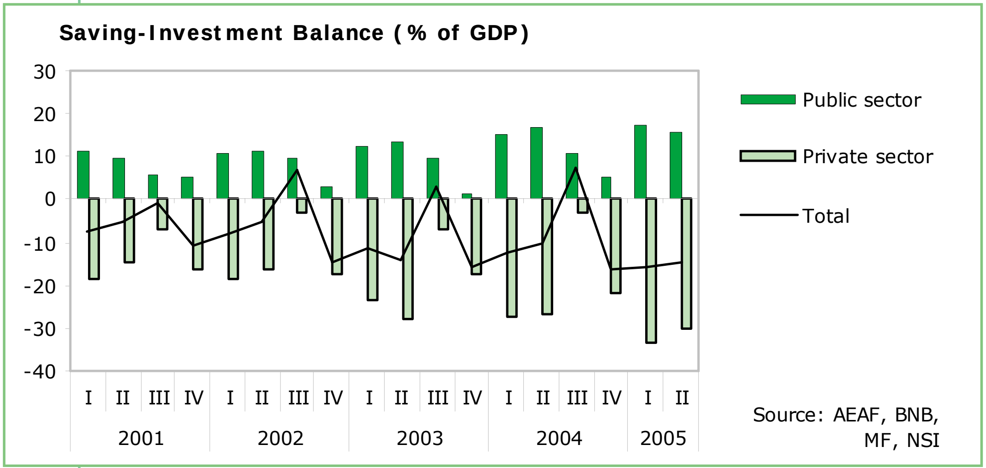
List of Abbreviations:

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

Macroeconomic Highlights

Growth in the Bulgarian economy gained further momentum in the second quarter of 2005. Q2 GDP data indicate that the economy carried on performing rather robustly, with growth picking further up in the last two quarters. The country's GDP stepped up to 6.4%, hitting a seven-year record high.

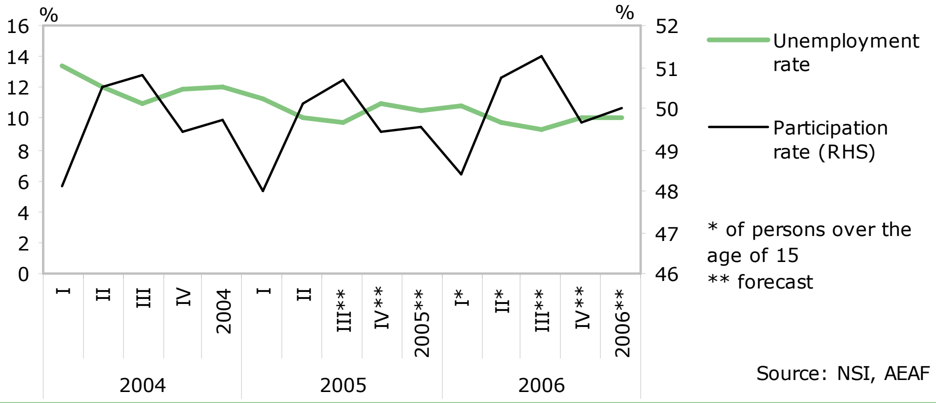
The main reasons for this year's strong economic performance have to do with the high growth rate of domestic consumption (9.4% up in second quarter on a year earlier). Household consumption also increased by 5.3% (at constant prices), as did investments by 16.8% (vs. 9.2% on a quarter earlier). The government sector reported a relatively high contribution to the ever-growing Q2 domestic demand. The share of public consumption in the stronger Q2 domestic demand ran at 1.3 percentage points, going well above the quarter's usual of around 0.8 points. The latter, however, may have been due to the increased government spending on the June parliamentary elections. Furthermore, capital expenditures posted a year-on-year rise of 70.2%, but despite its boosted investment activity, the government has turned out a net creditor in the economy. Steadying at their last year's Q2 level of 18% of GDP, public savings made up by and large for the scarcities of private savings in the economy (-4.4% of GDP) and curtailed the current account deficit.



The strong economic growth resulted in a sharp labour market upswing. Individual consumption stepped up mainly as a result of the growing wages and country's employment. At the same time, employment went on the increase due solely to the vigorous development of the private sector. Q2 private-sector employed numbers rose by some 90 thousand (4.4%) on a year earlier, whereas public-sector employed declined by 50.3 thousand (5.5%). The share of the private sector within the employed total went up as high as 70.9%, or 2.1 percentage points up on a year earlier. Public-sector employment, on the other hand, decreased due largely to the limited scope of the active labour market programmes in 2005.[1]

The stable macroeconomic environment, which boosted labour demand, gave rise to a continuous downward trend in the country's unemployment. As a result, Q2 unemployment rate stepped down as low as 10%, running 2 percentage points lower on a year earlier. The number of discouraged went down too. The participation rate (50.1%) in the second quarter declined by 0.4 percentage points on average relative to the same period of 2004 due to the fact that people who had abandoned their jobless status now joined the out-of-labour force cohort.

Unemployment Rate and Participation Rate*



Source: NSI, AEAF

Another factor fostering consumption had to do with wage growth in the economy. At preliminary NSI estimate (of the employed numbers and wages) Q2 average wages amounted to BGN 318, rising by 9.4% in nominal terms and 4.3% in real terms on a year earlier. Average wages amounted to BGN 394 in the public sector and BGN 280 in the private sector. Unlike 2004, Q1 and Q2 growth in public-sector wages now outstripped private-sector wages, reporting a real-term increase of 8.4 and 3.1% respectively. The upward trend in household income was further evidenced by household budget data. Money income per household capita posted a 7.9% year-on-year rise. At the same time, productivity[2] stepped up by 4.9% in the second quarter, running well above real growth in average wages.

High growth and sizable current account deficit. Foreign demand reported a 12% real-term growth as a result of the rebound of the EU economy (growth in the Euro area over the April-June period was up at 1.6% vs. 0.6% in the first quarter). At the same time, a key characteristic of the Bulgarian economy is that whenever growth picks up, the trade deficit goes on the increase, as does the current account of the balance of payments. In the eight months to September, the current account deficit stepped up as high as MEUR 1634.8, deteriorating by MEUR 913.4 on a year earlier.

[1] The above conclusion is based on monthly data from NSI Enterprise survey on the number of employed, time worked, wages and salaries, and other labour costs.

[2] Estimated as the ratio of GVA and the number of employed according to labour force survey (LFS) data.

The bulk of Bulgarian exports are associated with counterpart importation of raw materials. Furthermore, the boosted investment activity in the country has led to stronger investment imports, which in the eight months to September rose by MEUR 639.1, or some 34.4% on annual basis, accounting for 27.3% of the import total. And last but not least, the increased country's consumption was by and large met also by the growing consumer imports over the same period.

The high trade turnover was mostly due to the high prices of some main commodities like non-ferrous metals, steal and phosphates. The robust foreign metal demand predetermined the vigorous export growth not only in 2004 but since the start of 2005 as well. Raw material exports over the January-August period ran some MEUR 451.3 (20.7%) up on a year earlier. The exportation of investment goods has been sustaining a steady strong growth rate since last year (36.3% on a 12-month basis), now posting a relative share of 15.2% of the period's total exports. At the same time, the largest export item, clothing and footwear, the manufacture of which is labour-intensive and generates little value added, reported a seven-month decrease in export sales of 2.7% on a year earlier, induced most probably by the strong competitive pressure on the part of Chinese textiles.

Another factor affecting the country's trade balance had to do with the crude oil price dynamics worldwide. The import prices of crude oil in the eight months to September stepped up most dramatically by about 47% on an annual basis, making energy imports some MEUR 556.0 more expensive relative to the same period of 2004.

Also, while money transfers from Bulgarians working abroad, revenue from tourism and the smaller amounts of dividend payments made up for the trade deficit in 2004, this is not the case in 2005. The eight-month balance on net services was positive again, running, however, some MEUR 130.7 lower on a year earlier. In the seven months to August, revenue from travel rose by 9.6% up to MEUR 1427.8, whereas in the strong holiday months it reported an annual increase of 9.9%. Tourism is on its way to grow into a key factor in the Bulgarian economy, and the sizable investment injections alongside the modernization of the country's infrastructure suggest a robust development of the sector. And yet, it should be noted that 2005 witnessed a significant slowdown in its growth.

On a year earlier, net current transfers in the eight months to September went up by MEUR 0.3 whereas the income balance ran negative at MEUR 376.6.

At the same time, the financial account over the same period was positive at MEUR 1726.2 despite the ahead-of-schedule buyback of IABs and FLIRBs. FDI totalled MEUR 982.6, or some MEUR 162.2 down on a year earlier due to the smaller investment commitments along the lines of privatization in 2005. Nevertheless, FDI inflows covered about 60% of the current account deficit. The deposits of non-residents with local banks increased by MEUR 1.9, rising most drastically in February and March especially, only to go on the decrease ever afterwards due to the boosted lending of commercial banks in March in the wake of the clampdown on the rampant country's credit growth announced by the Central Bank.

The manufacturing industries - the most vigorously performing sector of the economy. The manufacturing sector posted a 9.3% increase in gross value added (GVA) in the second quarter. On a year earlier, growth in the processing industries picked further up to 11.5% in real terms, making a 2 percentage point contribution to

GDP. Export sales were again the main engine of growth in the manufacturing industries, posting a 17.1% real rise over the January-August period. In June and July, however, domestic sales went on the increase, catching up with export sales due to the concurrent growth slowdown in the export-oriented industries and boost in the domestic consumption of local industrials. The growth slowdown in the export-oriented industries was mainly fostered by the deteriorating terms of trade worldwide. On the other hand, the stronger competitive pressure on the part of Chinese textiles affected export sales in the clothing and textile industries most adversely and they stepped down by 4 and 1% respectively, whereas the domestic market share of local manufacturers was further undermined. The market situation worldwide had a detrimental effect on ferrous metallurgy and steel, cast iron and ferrous alloys manufacturing reported a most drastic 26.3% decrease in export sales in the eight months to September on a year earlier. However, any short-term improvement in the worldwide market situation is hardly expected, as China has undertaken measures to cool down its economy while increasing significantly its steel production capacity over the past few years. All this was coupled with the ever-rising US interest rates[3]. At the same time, another factor at work behind the sharp sales plunge in the sector had to do with the restructuring of Kremikovtsi Steel Works to take place in the wake of its sale to GSHL.

The significance of industries of higher value added such as machinery and equipment and electric machinery and apparatuses stepped up at the expense of the declining share of industries, making as a rule a strong contribution to growth like clothing and textiles. Non-ferrous metallurgy sustained its high growth rate, rising most robustly by 45%. The current growth-conducive copper price dynamics is to further persist and the industry is expected to perform in a rather strong manner at least until mid-2006. At the same time, any increase in gas prices is likely to have an unhealthy effect on the chemical industry, in particular on some of the manufactures where gas supply costs account for the bulk of production costs, e.g. fertilizers.

Gross output in the construction sector stepped up by about 25% in the first two quarters of 2005, hitting a record high since the first half-year of 1998. GVA also reported a remarkable growth rate in the first half-year period (14.2 and 13.8% up respectively) but lagged still significantly behind gross output. This may have been due to the slower rise in real estate prices and boosted supply, which made entrepreneurs decrease the profit margin in attempt to attract new customers. As result, the higher raw material and land prices have not been fully passed onto end-users. And yet, despite the increase, the profit margin in the construction sector remains significant and provides stable buffer stocks for both investors and entrepreneurs[4].

At the same time, agriculture was the only sector in the economy where value added ran negative (-5.2%) due to the backlog of problems faced by the sector. Also, agriculture is expected to make again a negative contribution to GDP growth in the next quarters as a result of the summer flood. Furthermore, it is still too early to assess the

[3] The main users of ferrous metals are construction and car manufacture, which are also very sensitive to the interest rate dynamics.

[4] The price cost of a square meter of housing area under construction is hardly ever expected to go well over EUR 250-300, given the current selling prices in the cities of EUR 500 and 600 on average.

effect of avian flu in the Balkan Peninsula in so much so that it is not clear yet whether or not the country has been affected by the problem.

The service sector posted a 6.4% increase in GVA. As a result of its large share within the aggregate indicator, the sector made the most robust contribution to GDP growth of 3.4 percentage points. Retail trade went on performing rather vigorously (reporting a 14.3% growth rate), giving way only to the financial service industry where value added stepped up by about 30% due to the high profit margin.

The quarter sustained the boosted bank lending. The restrictions undertaken by the Central Bank in early 2005 somewhat curbed the rampant credit growth in the economy. As of end-August, annual credit growth amounted to 39.5% running well below the growth rate of end-August'03 of 48.7% and end-August'04 of 50.2%. June credit growth ran even negative[5] due to the fact that the first base period for setting any additional minimum required reserves expired at the end of the month. In the following two months, however, credit portfolio growth steadied at 1.7%. At the same time, consumer loans carried on rising in volume terms, boosting consumption.

The structure of bank credit portfolio in the June-August period implies that the growth slowdown was triggered mainly by the decline in the trade credit extended, which may have a curbing effect on the country's economic development in the future. On the other hand, consumer loans went on the increase, and together with mortgage loans now enjoyed a larger share in the portfolio structure. It follows that while BNB's restrictions have put the brakes on credit growth curbing growth in some loans proved to be a tough task.

In order to make a profit by extra lending at minimum costs[6], commercial banks opted for the policy of deposit taking, launching huge advertising campaigns. As a result of the additional services and incentives offered to customers upon putting their money into banks, bank deposits rose most vigorously by BGN 1.2 billion in the period surveyed.

The policy of banks to become major deposit takers led to higher interest on time deposits in all key currencies. At the same time, the interest rates on short-term loans, but EUR-denominated credit, stepped down due to the fact that the bulk of loan extensions were in EUR and given the strong demand on the part of economic agents already in place there was absolutely no need for banks to lower the interest rates and further boost the otherwise robust credit demand. The interest spread between time BGN deposits and short-term credit in BGN was steadily narrowing throughout July to August to hit a record low of 4.12 as of the period's end.

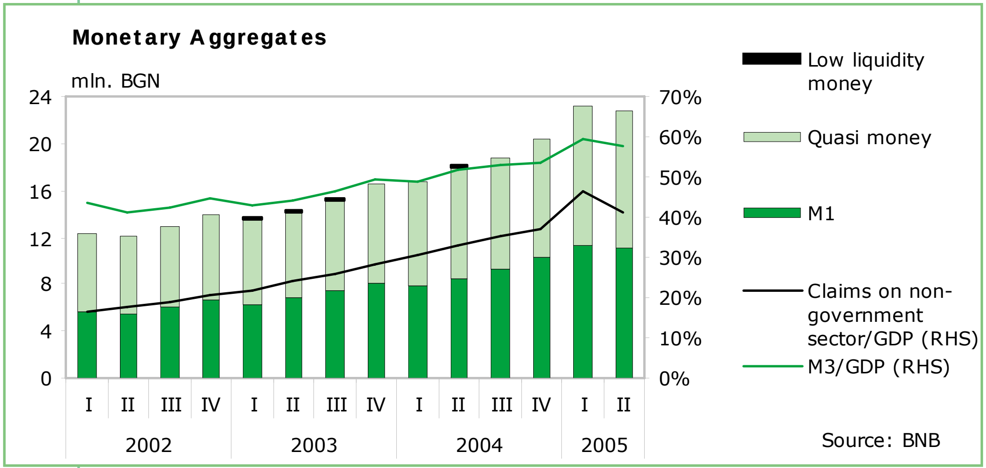
Commercial banks reported significant net profit (a year-on-year rise of 34.3% as of end-August). The bulk of the profit posted was due to the strong 12-month growth in net income from interest of 31.8%. At the same time, operating costs went on the increase, running significantly higher especially with the second bank group (339.2%

[5] A similar decrease in bank credit portfolios was discerned in April and May this year.

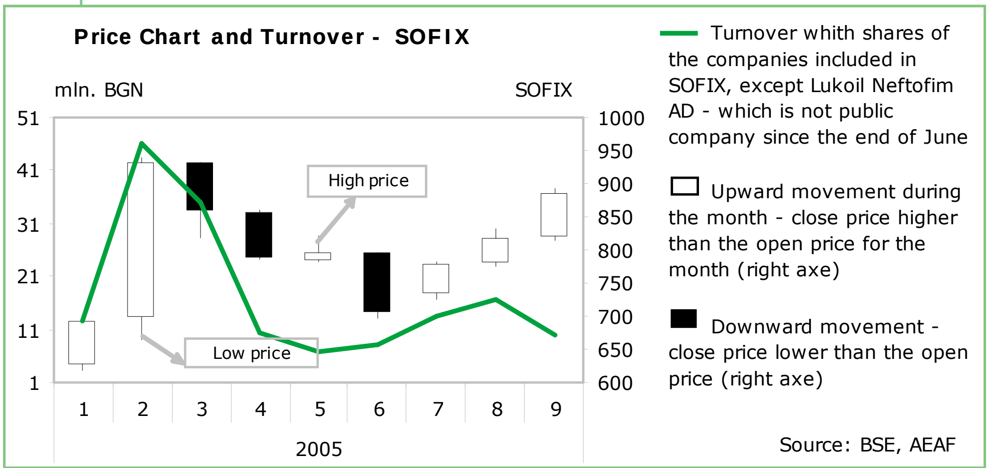
[6] It refers to some restrictions on the additional minimum required reserves as a result of credit growth higher than the one provided for in the relevant regulations. Furthermore it applies to cost minimization as BNB does not pay any interest on the additional minimum required reserves and banks may *de facto* lose income, which may have been otherwise earned have they resorted to alternative ways of using the financial resources.

of the operating profit in August'05). Net credit provisions improved, indicating that any credit portfolio deterioration is unlikely to take place at present.

Money supply reported a comparatively high growth rate (5.5% or BGN 1.2 billion) over the June-August period, prompted by the 8.5% increase of BGN 922.4 million in the most liquid monetary aggregate M1 having to do with the summer holiday season. On the other hand, M3 dynamics had to do with a rise in both net foreign and net domestic assets in the banking system.



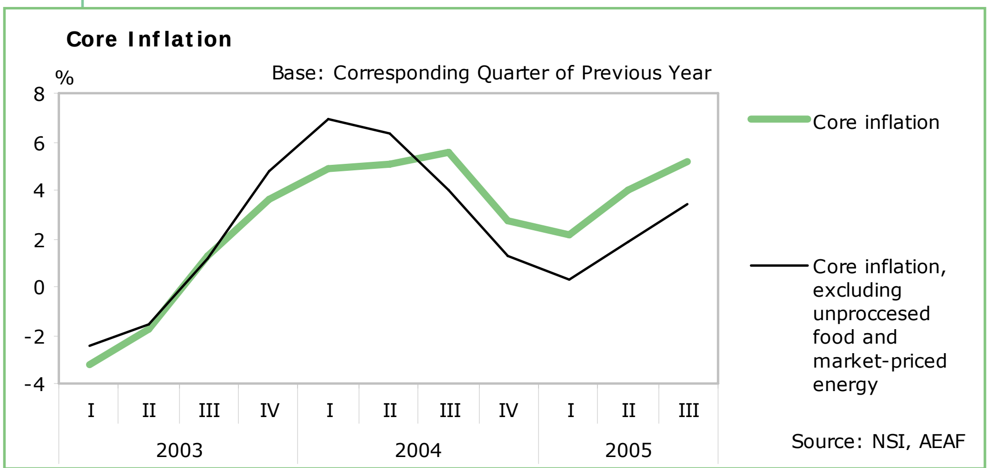
Net foreign assets stepped up solely at the expense of the quarter-on-quarter growth in commercial bank net foreign assets. The deposits of non-residents with local banks decreased whereas the deposits of Bulgarian banks abroad went on the increase. The above development was prompted by the recent practices of banks to sell some part of their credit portfolio to foreign banks.



The quarter-on-quarter growth in net domestic assets had to do with the credit increase in the same period. Non-government credit growth, however, ran well below the period's usual due mostly to the negative contribution of non-financial and financial enterprise credit, which declined by 0.6 and 16.1% respectively. A likely explanation for the decrease in non-financial enterprise credit was that banks opted to transfer the servicing of corporate loans to foreign banks. At the same time, household loans made up for the above decline, posting the most robust contribution of 9.6% (BGN 531.3 million) to the quarterly increase in net domestic assets.

The currency board arrangement remained stable and highly trusted by economic agents as the mainstay of the country's economic stability. BNB FX reserves reached 14.28 billion, though declining negligibly as a result of the July buyback of Bradies and debt payments to the IMF.

Vigorous stock exchange trading. Since the start of the year, both the stock exchange indices and volumes have reported significant fluctuations in the wake of BTC privatization and follow-up fresh injections of real-life money into the equity market. It is also possible that some part of this money has been re-channelled to the purchase of shares of the other listed companies, sending demand and, hence, prices too high. This was further evidenced by the turnover volatility reported by the companies, making up the SOFIX. As of end-February, the share prices of a number of companies hit levels that were difficult to account for by way of the key performance indicators reported hitherto and gave rise to the new price correction of end-February. Another reason had to do with the economic uncertainty related to the upcoming parliamentary elections and fears as to the unpredictability of the new government policies, exerting a certain downward pressure on prices. However, share prices started rising on the day immediately after the election date.



At the same time, note should be also taken of the turnover dynamics: whenever prices stepped up, turnover volumes followed suit, and vice versa – lower buying and selling quotations pushed trading down, indicating a basically positive attitude of market players. Therefore, the only possible explanation for the September drop in turnover volumes, coupled with the rising market prices, had to do with the uncertainty as to the short-term index's dynamics. On the one hand, it was the expectations that a new price correction is soon to take place, and on the other, that prices may well carry on rising, undermining supply.

Inflation ran slightly higher than expected due mostly to the oil and food price dynamics over the same period. Consumer price inflation stepped up by 1.90% in the seven months to August, while going up by 4.38% on a yearly average[7].

[7] January- August'05 on a year earlier.

Throughout May to August, unprocessed food prices were steadily declining, running, however, higher than the price drop of the preceding years. In July and August, processed food prices stepped up well over the normal seasonal change. The above unfavourable food dynamics was triggered by the summer floods and related thereto harvesting, yield and quality problems. Nevertheless, food prices since the start of the year reported a 1.65% drop.

Crude oil price world wide had been steadily rising ever since May due to the poor weather conditions and some speculative factors at work, soaring well over USD 70 per barrel. As a result, local fuel prices posted a 14.85% quarter-on-on-quarter increase while going 28.62% up since the start of the year. In addition, cumulative fuel price inflation led to a rise in the transport service rates of 2.33% on average.

Free price inflation over the January - August period (period's cumulative) amounted to 1.49%, making a 1.17 percentage point contribution to overall inflation.

Administered prices in the eight months to September advanced by 3.40%. In July, heating prices (for water warm-up purposes) rose by 9.36%, and the item reported an aggregate increase of 2.63%. The contribution of administered prices to consumer price inflation amounted to 0.73 percentage points.

A record high cash surplus. Higher than the budget projections indirect tax revenues and prudent spending policies were again the key items on the fiscal programme agenda in the first half-year period of 2005. As of end-August the general budget cash surplus ran as high as BGN 1.3 billion, accounting for 3.2% of the 2005 GDP expectations. All this shows that the commitments undertaken by the country under the IMF arrangements that the budget should end the year with a surplus of at least 1% of GDP will be satisfactorily met, provided cautious spending policies are further sustained by the end of the year.

The robust growth of 13.4% (9.3% on a consolidated basis) throughout the period surveyed was solely triggered by tax revenues, the over-performance of indirect tax revenues in particular. Despite the exceptionally high last year's growth base, VAT revenues alone stepped up by 30.3%. As of end-August, the revenue performance of customs duties and the other two indirect tax items ran at 96.2% and 70% respectively due to the strong import growth and higher excise duty rates and oil prices. On the other hand, as a result of the lower rates in force since the start of the year, profit and personal income tax revenues reported a slight decrease on a year earlier, as did non-tax revenues. On a year earlier, budget expenditures went up by 16.4%, reporting performance of 62.9% as of end-August. The above increase had to do with the higher spending on maintenance, doubled capital expenditures as a result of the boosted investment activity as well as with the higher transfer amounts to the social insurance funds in particular. At the same time, the increased general budget expenditures were by and large due to the higher local government spending in relation to the damages caused by the summer floods.

As a result of the altered debt policies, the structure of the government debt underwent significant changes in July, with the debt of fixed interest coupon now enjoying a higher share of 51.76%.

Forecasts

External Forecasts

Q3 average oil prices ran some USD 10 higher than earlier estimates as a result of the tightened relations between Iran and the USA as to Iran's nuclear programme and the damages suffered by the US oil industry in the wake of the hurricanes. All this exerted some extra pressure on trading and in end-August futures market prices stepped up well over USD 70 per barrel. However, as a follow up, some of the big economies had recourse to market interventions by unblocking their strategic reserves and oil prices set back at slightly over USD 60 per barrel in September. Current estimates do not provide for any further increase in oil prices for two main reasons: first, consumption is already on its way to turn to alternative sources of car fuels, and second, there are all the indications in place of a certain slowdown in global growth prompted by the excessively high oil prices. Therefore, with a view to the coming winter months, current forecasts draw on some USD 62-63 per barrel in the last quarter, and an insignificant price decrease ever afterwards.

The soaring oil prices made inflationary expectations even stronger, sending in turn interest rates rather high. Following the second quarter stabilisation, US inflation in the first two months of the third quarter ran well over 3% on an annual basis, going as high as 3.6% in August. All this made the Fed carry on raising US interest in a gradual manner. As a result, the LIBOR (in USD) stepped up higher than the earlier estimates, giving rise to some revisions in Q4 assumptions. US interest rates are to go on rising in 2006 as well at a slower rate, though, according to current estimates.

The high oil prices had an adverse effect on inflation in the Euro area, which advanced to 2.5% on an annual basis. This in turn strengthened the expectations that European Central Bank would respond by steadily raising the interest rates. Current estimates rely on a smooth interest rate rise in the Euro area as of early-2006. Nevertheless, the interest rate difference between the USD and the EUR will be further sustained, favouring the US currency. In addition, the current forecasts do not point to any sharp EUR/USD exchange rate volatility while providing for an insignificant increase in the US currency.

Furthermore, current estimates sustain the underlying assumptions as to growth in the global economy and Bulgaria's major trading partners. Q2 growth in the Euro area ran slightly higher vis-a-vis earlier projections but due to some Q1 revisions, given the same growth rate of the past two quarters, 12-month growth has been revised downwards by a 0.1 percentage point to 1.5%. 2006 growth, on the other hand, is to pick up by some 2% on an annual basis fostering Bulgarian exports.

Forecasts

GDP

Current forecasts rely on a 0.4 percentage point increase in 2005 real growth (5.6%) due to both the higher than expected Q2 growth and the revisions for the other two quarters having to do with government spending.

The higher government spending in the second quarter vis-a-vis AEAF expectations boosted both final consumption and investments, which in turn gave a strong push to GDP growth. With a view to the robust performance of this year's budget and expenditures to make up for the flood damages, investments and consumption are expected to report a higher rise compared to earlier forecasts. As a result, Q3 and Q4 growth in both investments and final consumption has been revised upwards by 6.5 and 4.5 and 2.1 and 0.5 percentage points respectively. On the other hand, due to the stronger domestic demand imports gained further momentum, and import growth has been revised upwards by 2.0 and 1.3 percentage points in the third and fourth quarters. At the same time, real export growth has been slightly understated as nominal growth will be due to export prices rather than volumes, an assumption sustained by earlier estimates. All this considered, Q3 and Q4 GDP is expected to rise even higher by 0.2 and 0.3 percentage points.

2006 will sustain the strong performance of the economy of the past few years. GDP growth is to run at about 5.5% in real terms due mainly to the rapid development of the external sector. On a year earlier, exports are to grow faster in real terms, whereas imports are to step down. As a result, the contribution of net exports is to improve from -3.0 percentage points to a solid -1.0 point. It should be also noted that final consumption (4.1 percentage points) is expected to make a most robust contribution to 2006 GDP growth, slowing, however, down relative to 2005. This will be due to the year-on-year decrease in government spending as well as the slower growth in household consumption. The high consumption of the last few years, as triggered mostly by the boosted bank lending will squeeze the growth potential of the aggregate indicator. Similar considerations lie at the core of the assumptions as to a lower real investment growth (of slightly over 9%) in 2006 compared to the preceding years.

A breakdown of 2006 GDP by quarter is given in Table 27. On the whole, 2006 GDP is expected to grow throughout the year at a rather moderate rate. The high GDP growth of the first half-year period of 2005 will account for the relatively lower growth in the first and second quarters of 2006, whereas the usually strong external sector in the third quarter will prompt a relatively vigorous growth rate in the same quarter.

Inflation

The extensive flood damages suffered by road infrastructure and farm land (agricultural output volumes reported a 5.2% decline in the second quarter) exerted an upward pressure on price inflation, food prices in particular, due to the downbeat expectations as to this year's yields, crop quality and, last but not least, possible price speculations. Furthermore, the consumer price level is to further step up as result of the crude oil price dynamics. According to AEAF estimates, crude oil prices will go on rising by the end of the year. This and other external factors at work have led to an increase in the 2005 inflation expectations (See the table on page 27).

2005 core inflation is to run at 5.31%. Car fuel prices are to increase by 15.82%, posting a contribution to total inflation of 0.83 percentage points. The higher fuel prices entailed a rise in fares. All this together with the price adjustments of BTC of April will bring about a 12-month aggregate increase in market service prices of around 7.84%. Food prices are to go up by 4.59% while unprocessed food is to report a price rise of 6.04%. The effect of fuel and food price inflation excluded, free prices are to advance by 4.51%. The aggregate contribution of all free price items to total inflation is estimated at 4.18 percentage points.

In 2005 ***administered prices*** are expected to step up by 4.19% vis-a-vis earlier estimates due mostly to the increase in heating prices, having to do with the more expensive fuel prices, gas in particular. The contribution of administered prices to the country's inflation is to amount to 0.89 percentage points.

Consumer price inflation is expected to run at 5.07% in end-2005 and 4.71% on a yearly average.

2006 inflation forecasts depend heavily on the tax policies of the government, especially the schedule to be applied to the higher excise duty rates on some goods enjoying a rather large weight in the consumer basket, e.g. tobacco products and fuels. Current estimates draw upon the assumptions that the new excise duties on tobacco products will be instituted in 2006 in the amounts and rates originally foreseen for 2008, whereas the excise duty rates on spirit drinks negotiated with the EU will be applied in 2006 instead of 2007. In addition, 2006 is to see an increase in the fuel excise duty rate in compliance with the results of the negotiations on the harmonization of the minimum excise duty rates on petrol.

Next year ***free prices*** are to rise by 2.69%. The 12-month increase in fuel prices is expected to amount to 0.23%. The relatively small growth vis-a-vis the ever-rising excise duty rates is based on the supposition that crude oil prices in 2006 will start declining, going on a steady downswing. Market service prices are to step up by 7.10% due to the indirect effect of the more expensive energy prices and the Balassa-Samuelson effect. Food price inflation is to advance by 1.62%. The contribution of free prices to total inflation is estimated at 2.12 percentage points.

Administered prices are expected to go up by 14.47% in 2006 as a result of the robust increase in tobacco prices of 65% having to do with the higher excise duty rates to be applied since the start of the year. Their contribution to the country's inflation is estimated at 2.34 percentage points. In addition, electricity and heating prices are to undergo further adjustment. As a result, the contribution of administered price inflation to overall inflation is to run at around 3.08 percentage points.

End-of -2006 inflation is expected to amount to 5.20% whereas prices are expected to step up by 6.26% on a year earlier.

Employment and the jobless rate

The robust growth the Bulgarian economy is expected to report by the end of 2005 and throughout 2006 provides a solid ground for the continuous labour market upswing.

2005 employment is to rise at a slower rate of about 1.3%[8] due mainly to the weaker contribution of the active labour market programmes of the government anticipated. As a result, the jobless rate is to step down rather slowly. Q3 unemployment is to decline to about 9.8%[9] due mainly to the stronger demand for seasonal labour in the primary market only to advance again as of the year's end to 10.9% as a result of the seasonal shrinkage in employment and re-signing up with the job centres of those have been involved in the temporary employment programmes. The 2005 unemployment rate is expected to run at around 10.5% on average, going some 1.5 percentage points down on a year earlier. Next year's unemployment will carry on decreasing at a considerably lower rate, steadying about 10% on average. However, even given the intentions of the government to raise the employed numbers under the active labour market measures and programmes, the contribution of the latter to the declining country's unemployment will be rather little. Therefore, any reduction in 2006 unemployment and hence rise in the country's employment (by about 1.4% on an annual basis) will be due to the boosted business activity of the private sector, which is to further foster labour demand and job creation. At the same time, the resources to be made available from the reduced social insurance burden are not to be re-channelled to new job creation immediately. The above effect will manifest itself in the next couple of years, prompted by the improved terms of business and higher investment activity in the economy.

The slower growth in 2005 employment is expected to lead to a lower participation rate in the economy[10], which is to step down insignificantly by a 0.1 point on an annual average to about 49.6%[11] on a year earlier. In 2006, however, the rate is to go on the increase to 50% due to the sustainable employment in the private sector, on the on hand, and the declining discouraged numbers expected to join the labour force again, possibly contributing to the slower decrease in the jobless rate.

Income and Productivity

Average wages as well as productivity[12] will keep on rising in the next two quarters. However, on an annual basis, 2005 growth in productivity will outstrip real growth in average wages.

Relative to 2003 and 2004, spurred by the rapid development of the private sector average productivity in the economy is to step up at a higher rate entailing a stronger real rise in wages. In addition, as 2006 is expected to sustain the upward trend the indicator will outstrip real wage growth again, favouring competitiveness.

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[8] The above estimates as to the growing employed numbers rely on labour force survey data.

[9] By definition of LFS.

[10] Of 15 years of age and over.

[11] Current forecasts run some 0.2 percentage points lower vis-a-vis earlier expectations.

[12] Estimates draw upon GDP data and the labour force survey findings as to the number of employed.

Balance of Payments

Growth in both exports and imports by the end of the year is expected to run well over 20%, producing a most adverse effect on the current account. Exports are to step up, as fostered by the improved competitiveness of Bulgarian goods, the growth-conducive price dynamics world wide, stronger foreign demand and relatively small USD's exchange rate fluctuations to the single European currency. At the same time, imports will remain strong as a result of the boosted lending and investment activity in the country, ever-rising raw material demands of the export-oriented industries as well as the main commodity prices in the international markets.

According to AEAF estimates, the 2005 current account deficit is to hit a record high of 10.9% of GDP, deteriorating most drastically vis-a-vis earlier forecasts, as follows: January (7.3%), April (7.7%) and July (8.5%). The forecasts revisions made throughout the year have been triggered by the excessively high trade turnover, sending the country's trade deficit as high as 17.4% of GDP. This, together with the assumptions as to foreign demand and worldwide price dynamics shaped the 2006 forecasts.

Bulgaria's accession to the EU and improved competitiveness of local goods alongside the sound growth rate expected in the global economy, the EU in particular, in 2006, provide for a strong export growth of about 12% in real terms. Real import growth, at the same time, is expected to amount to some 11%, based essentially on assumptions that both consumption and investments will go on the increase.

On the other hand, the expectations are that the main commodity prices are not to rise drastically in 2006 as it happened in 2004 and 2005. Non-ferrous metal prices (in USD) are anticipated to hold steady at their 2005 level or step up slightly, whereas ferrous metal prices are to decline. In addition, higher crude oil prices will lead to more expensive imports. The scenario draws upon a 14% increase in average prices (in USD) on a year earlier. At the same time, the single European currency is to be slightly cheaper to the USD throughout the year. Therefore, based on the above expectations, the export and import deflators are to run at about 2-3%, and nominal-term growth is estimated at 13-15%, with the trade deficit holding steady at its 2005 level of about 17% of GDP.

Given the performance since the start of the year, net services are expected to cover only 20% of the trade deficit. However, in 2006 the ratio is to improve to some 25%, with revenues from tourism rising by 15% on a 12-month basis due to the robust investment injections in the industry and relatively good conditions for holiday making in Bulgaria.

The 15% growth in private current transfers and over MEUR 300 of EU pre-ins amounts expected will make up partially for the even huger trade deficit in 2006. In the mid-term, significant allocations from the EU pre-ins and structural funds may curtail the current account deficit while giving rise to some additional importation.

Over the past couple of years FDI have, as rule, fully covered the current account deficit, now making up for about 70% of the 2005 deficit. The expectations are that 2006 FDI inflows will offset about 90% of the deficit. On the whole, however, the financial account surplus is to fully cover the current account deficit in both 2005 and 2006. Despite the higher interest rates in the USA and EU in the same years expected, the cash inflows on the financial account are to be sustained due to the interest spread and high return on loans in BGN. The Central Bank's restrictions on the country's credit growth will affect foreign financing and urge a more active borrowing on the part of the non-financial sector from foreign lenders.

At the same time, the above flows tend to generate further importation and any decrease in their size will result in a lower current account deficit. In the medium term, however, the balance of payments is not expected to exert a downward pressure on BNB FX reserves.

Budget

General budget revenue forecasts by the end of the year remain almost unchanged vis-a-vis earlier estimates. The strong Q3 performance lived up to expectations, bringing about some insignificant changes in the revenue structure only. The vigorous growth in imports is to result in higher VAT revenues. In addition, the above forecasts accommodate a double pay in December in the budgetary sector, although the government has not yet come up with a final decision. However, provided there is no double remuneration, revenues from the personal income tax are to run some BGN 25-30 million lower than expected. At the same time, grant estimates have undergone substantial revisions. Q2 grants posted a most robust rise on a year earlier, which, however, was fully offset by the poor performance of the revenue item in the first quarter. Practically speaking, the comparison of the first half-year period grant revenues in the aggregate has pointed to a year-on-year decrease, refuting the upward revisions in the earlier 2005 estimates.

2006 revenues are to amount to a total of BGN 19.2 billion, accounting for 41.4% of GDP due mostly to the cut-down in the social insurance burden planned and sharp increase in the excise duty rates on cigarettes and spirit drinks. The overall direct effect on budget revenues is expected to run negative at about BGN 500 million. These estimates, however, do not encompass the indirect effect on VAT revenue of the higher excise duty rates, which will inevitably raise the taxable base. VAT is expected again to be the key source of budget revenues, with the 10.3% annual rise being the result of the steady import growth and extra revenues from the higher excise duty rates. Profit taxation is not to see any serious alterations and revenues thereof will step up in line with GDP's nominal-term growth. The first quarters of the year are to see a lower revenue inflow as the compensation payments due are to step down on an annual basis as a result of the reduced tax rate. The amendments to the personal income tax brackets planned are not to lead to any loss for the budget and personal income revenues are expected to post a significant increase. The 7.9% year-on-year rise in the revenue amounts from the above item projected has to do with the steady growth in both employment and average wages.

Public sector forecasts draw upon a balanced budget in 2006 vs. a surplus of 1.7-2% of this year's GDP. The sizable 2005 surplus has been the result of the IMF arrangement whereby 50% of the revenue over-performance is to be saved. The tax incentive package planned for next year will, however, fully make up for the lower target level of the budget balance and revenues are to remain unchanged as a percentage of GDP. At the same time there is to occur a certain shift on the revenue side towards a higher share of investments due to the stronger absorption capacity expected of ISPA funds. All this considered, the public sector will carry on making a positive contribution to economic growth along the lines of government consumption while going on a steady decrease as from 2006 onwards.

Public-sector estimates have been based on a number of assumptions as to 2006 government fiscal policies. Therefore, a major forecast error may evolve from alterations to the policy intentions of the Finance Ministry already stated, with the amendments (not yet voted by Parliament) to the current tax rates enjoying the heaviest weight. As already pointed out, on the expenditure side, a key assumption is associated with the higher capital expenditures, which pre-determine the free amounts to be used up by the government.

Financial Sector

2005 growth in money supply is to run at about 22% or slightly lower vis-a-vis the earlier estimates of 24% due mostly to the declining growth in private-sector credit. Money supply growth in 2006 is to further slow down as a result of the continuous sale of corporate credit to foreign banks. Prompted by credit transfer, the significance of domestic credit to broad money growth is to step down. However, it is to be partially offset by the growing net foreign assets in the banking system.

As in the second half-year period of 2005 corporate loan interest already decreased to levels applicable in the EU member states, in 2006 it is expected to hold steady around the current levels. However, a slight decrease is also likely have banks sustained the same lending rate and also in the wake of EU convergence. On the other hand, if lending is to go on the decrease and credit portfolio quality deteriorates, interest rates are to be raised to accommodate the higher lending risks. Furthermore, time deposit interest is to remain more or less unchanged by the end of 2006. At the same time, due to the temporary flight of foreign resources from the local banks long-term credit interest may go on the increase unless non-resident deposits start rising again.

Credit growth by the end of 2005 and in 2006 is hard to estimate for two main reasons as follows: on the one hand, the Central Bank is about to take further measures to put the brakes on lending, including some new amendments to the regulations and legislation in force. On the other, the on-going practice of banks to transfer some part of their credit portfolio to foreign counterparts leads to a somewhat artificial contraction in real credit growth. For this and other reasons, the estimated credit growth is susceptible to revisions. Therefore, 2005 growth is expected to run at about 37 – 38%, going down to about 30% in 2006 as a result of the credit regulations in force now. ❍

Forecast Errors

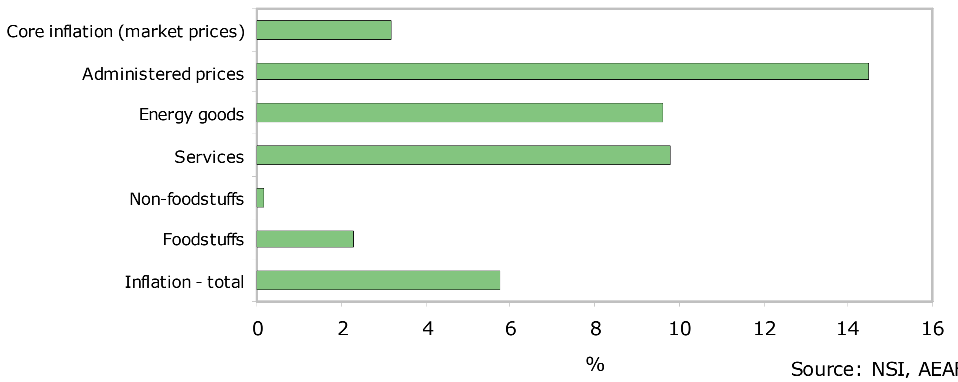
- A likely postponement of the EU negotiated increase in excise duty rates will undoubtedly lead to downward forecast revisions.
- The above forecasts do not accommodate the effect of any new BNB clamp-down on the country's credit growth.
- A likely increase in the imputed rental value of owner-occupied housing may led to a higher nominal GDP.
- Oil price dynamics remins a major source of forecast errors. ❍

Mid-Term Inflationary Developments

Inflation has been in the spotlight for quite a few months now due mainly to the following two reasons: 1) the worldwide oil price dynamics since mid-2004, which sent the local prices of refined oil products rather high and raised expectations as to a price increase in other goods and services along the lines of inter-industry links; 2) the stated policy intentions of the government to raise some of the excise duty rates. The implementation of this measure has to do with the outcome of the arrangements achieved in the negotiation process, whereas its application at an earlier date is associated with Bulgaria's commitment to fulfil certain criteria in the wake of its accession to the EU and its willingness to join the Euro area as soon as possible.

Following the institution of the currency board arrangement there has been in the country price stability and one-digit inflation achieved amidst all-embracing structural reforms and several external to the economy shocks.

Average Increase of the Consumer Prices in 1998-2004



Source: NSI, AEAF

Since 1998 the inflationary process has come down to relative price changes mostly rather than a continuous advance of the overall price level. The very low initial base of bringing income and prices in line with the developed economies, the EU in particular, together with the administered price adjustments have resulted in a significant relative price change. The increase in market service prices outstripped cumulative price change by 25% while the relative prices of food and non-food items lagged considerably behind by 18 and 28% respectively. Administered price adjustments have made the strongest contribution to overall inflation. Accordingly, relative administered prices exceeded inflation by 60%.

The Maastricht Criterion of Price Stability

As agreed, the Bulgarian government and the Central Bank will seek ways to "join the Euro area and hence adopt the single European currency immediately after the said date of Bulgaria's accession to the EU". As a first step they are to "apply for accession to exchange rate mechanism II (ERM II) immediately after the date of official membership of the country in the EU"[13]. Therefore, a major challenge the country will have to face in an ERM environment has to do with the price stability criterion of convergence. The latter, however, is estimated on the basis of average inflation in the three best-performing Member States by adding up another 1.5 percentage points. The period of criterion fulfilment is 12 months preceding the examination of the situation in the said member state, and the index whereby inflation is gauged is the harmonized index of consumer prices (HICP).

If Bulgaria is to enter the Union on 1st January 2007, price stability in the country will then depend heavily on the inflation rate in 2008. According to AEAF estimates, average annual inflation in 2007 is to run at about 3.1% and further down at around 2.8% in 2008. 2008 estimates are close to the 2004 target inflation rate of 2.4% announced by the ECB. This target is, however, difficult to achieve, taking note of the inflation data of the preceding years and now as well as the factors, accounting for the overall price change. In addition, it should be also noted that in terms of methodology the CPI, as calculated by the NSI, does not fully meet the HICP requirements of Eurostat.

Likely Sources of Inflation over the 2007-2008 Period

Bulgaria has to bring its tax policies, indirect taxes including, into line with the EU acquis

The alignment of the local excise duty rates started in 2001 and is about to end some time in 2010. The earlier adjustment in some of the rates under the Bulgaria-EU agreements and arrangements is to result in a significant but one-off increase in the CPI in 2006. At the same time, its effect on inflation is expected to manifest itself earlier than 2008, which is vital to the achievement of price stability. Therefore, the upward pressure of the higher excise duty rates on inflation in the first years of EU membership will be significantly lower.

Administered price adjustments – inevitable even after the country's accession to the EU

Administered prices, the prices of electricity for household purposes in particular, are expected to go on the increase in the next couple of years. The State Commission on Energy and Water Regulation (SCEWR) has been so far successfully declining the demands of the district energy supply companies for more expensive electricity prices ever since the start of market liberalization and a year after the termination of the 3-year stepwise schedule for an annual centralized increase in heating and electricity prices in 2004. Currently, however, it is rather difficult to foresee what the exact timing

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[13] Agreement of the Council of Ministers of the Republic of Bulgaria and the Bulgarian National Bank on the adoption of the single European currency, dated 25th November 2004.

and proportion of another price rise will be. The removal of the so-call "social price" of day-time electricity of 75kWh alone[14], at the request of the World Bank is estimated at some 1.4 percentage point contribution to inflation. Therefore, any further adjustment in administered prices and the excise duty rates will remain a major source of consumer price inflation while failing to affect the inflation total so strongly.

Strong impact of the external environment

As Bulgaria is a small and open economy free price inflation depends largely on the interplay of external factors: crude oil and other raw material price dynamics world wide; the USD/EUR exchange rate and import price inflation. The more expensive oil prices affect the manufacturing industries and consumer price inflation not only directly but also indirectly by raising production costs in industries seemingly not dependent on fuel prices or by imposing a certain restructuring in household spending and consumption patterns. At AEAF estimate, the direct effect of the 10% crude oil price rise on consumer prices amounts to 0.3, whereas the indirect effect runs at 0.4 percentage points.

Domestic demand

With the currency board arrangement in place and macroeconomic stabilization achieved, Bulgaria has become a relatively rapidly growing economy. This, however, has given rise to the so-call structural inflation most often accounted for by the Balassa-Samuelson effect and led by the income and price adjustment to EU levels.

The next few years will have to sustain the sound ratio of productivity growth to real wages achieved. Throughout 1998 to 2004 productivity growth (period's cumulative) tended to outstrip wages. Any turnaround in this trend, however, may exert an upward pressure on domestic prices. At the same time, it should be noted that well until 2001 the country's employment was steadily declining, whereas employment by 2008 is to go on the increase as a result of the boosted private-sector business activity perpetuating a robust demand for labour.

The manifestation of the Balassa-Samuelson effect is to be assessed taking into account the economic performance of Bulgaria's trading partners. The different growth rate of productivity between the sector of tradables and non-tradables in the country vis-a-vis EU-15 accounts for the different inflation rates. Relative average productivity in Bulgaria – tradables to non-tradables ran some 2.1 percentage points higher than in EU-15, whereas local relative prices – non-tradables to tradables surpassed EU-15 relative prices by 2.5 percentage points over the 1998-2004 period.[15] At AEAF estimate, the one percentage point higher relative productivity in Bulgaria vis-a-vis EU-15 resulted in a 0.3 percentage point increase in the aggregate deflator of gross value added (GVA). i.e. GVA over the 1998-2004 period in Bulgaria ran some 0.6 percentage points higher than in the EU-15. The next couple of years are expected to see a lower contribution to overall inflation as the effect of the above trend is to steadily fade away.

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[14] The State Commission on Energy and Water Regulation (SCEWR) removed the cheaper night-time rate of electricity consumption up 50 kWh applied to end-users five months a year.

[15] The above estimates rely on GVA data. The price effect calculated refers to the value added deflator.

NSI CPI vs. EU HICP

The CPI, as calculated by the NSI, has not yet been brought fully into line with Eurostat requirements. CPI estimation relies on household money expenditure data from the household budget surveys as a major source of information on weights. They, however, take no account of the expenditures of non-residents made on domestic territory. Therefore, the index currently in use does not comply with “the domestic concept of constructing HICP weights” [16]. According to NSI estimates, the above concept leads to a profound change in weights, as a different structure will yield different results, i.e. a price index other than the one (CPI) currently employed for statistical purposes. It follows that the institution of the concept is a mandatory step to making the local CPI consistent with the HICP. The faster amendments to methodology will make the local index relevant to EU estimates. All this will facilitate inflation forecasts because so far analysts have handled an index that is locally applicable (as is the case with many countries) and, yet not exploited in gauging inflation in the Community or the EMU. ❍

[16] A. Dantcheva, R. Tsonkova, ***Implementation of the Domestic Concept into Bulgarian HICP. Two Possible Approaches to HICP Weight Construction***, NSI WG on HICP, Malta Workshop, La Valetta, 24-25 May 2004.

Macroeconomic Indicators 2003 - 2005

		Reported data				Forecasts										
		2004	Q1	Q2 2005		Q3 2005		Q4 2005		2005		Q1	Q2	Q3	Q4	2006
			2005*	forecast	reported	previous	revised	previous	revised	previous	revised	2006	2006	2006	2006	
Exchange rate USD/BGN, p.a.		1.6	1.49	1.55	1.55	1.60	1.60	1.59	1.59	1.56	1.56	1.60	1.61	1.62	1.63	1.61
Petroleum spot price (APSP)		37.8	46.2	50.8	50.8	51.0	60.0	50.0	61.5	49.5	54.6	62.3	62.0	61.8	61.0	61.8
EU Area Real GDP growth	%	1.7	0.6	1.5	1.6	1.8	1.8	2.1	2.1	1.6	1.5	1.7	2.0	2.2	2.3	2.1
LIBOR U.S. dollar deposits	%	1.9	3.1	3.5	3.5	3.8	4.0	4.1	4.3	3.6	3.7	4.4	4.5	4.6	5.6	4.8
GDP, current prices	mln. BGN	38 008	8 690	9 584	9 738	11 580	11 650	11 223	11 460	41 077	41 536	9 774	10 672	12 991	12 585	46 022
GNP, current prices	mln. BGN	37 342	8 386	9 388	9 554	11 410	11 243	11 049	11 373	40 249	40 555	9 504	10 429	12 597	12 480	45 015
GDP, real growth	%	5.6	6.0	4.9	6.4	5.3	5.5	4.7	5.1	5.2	5.6	4.9	5.2	6.2	5.3	5.5
Consumption, real growth	%	5.0	7.3	5.0	5.9	4.0	6.1	4.6	5.0	5.1	5.9	4.3	5.0	4.7	4.4	4.7
Investment, real growth	%	14.8	8.5	8.0	22.2	9.0	15.6	7.1	11.6	8.0	14.5	11.0	8.5	8.7	9.3	9.3
Exports GNFS, real growth	%	13.1	8.8	11.5	12.0	12.2	9.8	10.0	9.0	10.8	9.9	11.5	11.8	11.9	12.8	12.0
Imports GNFS, real growth	%	14.1	10.8	11.6	15.5	12.4	14.3	9.1	10.5	10.9	12.8	11.0	11.2	11.0	11.0	11.1
Inflation, corresponding period of previous year = 100	%	4.0	2.0	1.2	1.2	1.3	3.2	3.6	5.1	3.6	5.1	4.1	2.3	3.7	5.2	5.2
Inflation, previous year = 100	%	6.2	3.6	4.4	4.4	2.9	4.3	5.0	6.5	4.0	4.7	6.4	5.9	5.5	7.3	6.3
Core inflation, corresponding period of previous year = 100	%	4.6	2.2	3.9	4.0	3.5	5.2	4.0	5.7	3.4	4.3	5.6	4.2	3.3	2.9	4.0
Administrative prices, corresponding period of previous year = 100	%	11.0	8.7	7.7	7.7	3.2	3.8	3.6	4.2	5.8	6.1	14.6	13.4	15.2	14.7	14.5
Current account balance	mln. EURO	-1 447	-708	-518	-735	449	-161	-1 009	-1 034	-1 782	-2 638	-672	-774	172	-1 135	-2 408
Current account balance, % to GDP		-7.4	-15.9	-10.6	-14.8	7.6	-2.7	-17.6	-17.6	-8.5	-12.4	-13.4	-14.2	2.6	-17.6	-10.2
Exports	mln. EURO	7 994	2 078	2 322	2 304	2 585	2 599	2 599	2 665	9 583	9 645	2 483	2 668	2 962	3 007	11 120
Imports	mln. EURO	10 712	2 729	3 263	3 346	3 169	3 426	3 700	3 843	12 861	13 345	3 222	3 816	3 802	4 302	15 142
M3, p.a.	mln.BGN	18 033	20 798	22 429	22 367	23 457	23 480	24 530	24 577	22 976	22 978	26 951	27 885	30 054	31 122	29 003
Reserve money, p.a.	mln.BGN	5 505	6 447		6 827		7 483		8 331		7 272	8 192	8 324	9 392	10 105	9 003
Total revenues	mln. BGN	15 855	4 167	4 616	4 678	4 398	4 343	4 773	4 811	17 954	17 998	4 353	4 907	4 716	5 191	19 166
Tax revenues	mln. BGN	12 774	3 404	3 528	3 530	3 560	3 563	4 010	4 010	14 502	14 507	3 644	3 806	3 869	4 293	15 612
Unemployment rate	%	12.0	11.3	10.6	10.0	9.8	9.8	10.5	10.9	10.6	10.5	10.8	9.7	9.3	10.0	10.0
Participion rate	%	49.7	48.0	50.6	50.1	51.2	50.7	49.5	49.4	49.8	49.6	48.4	50.7	51.2	49.7	50.0

* Balance of payments, EU Area Real GDP growth and LIBOR data are revised

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