THE BULGARIAN ECONOMY: ANALYSIS AND OUTLOOK

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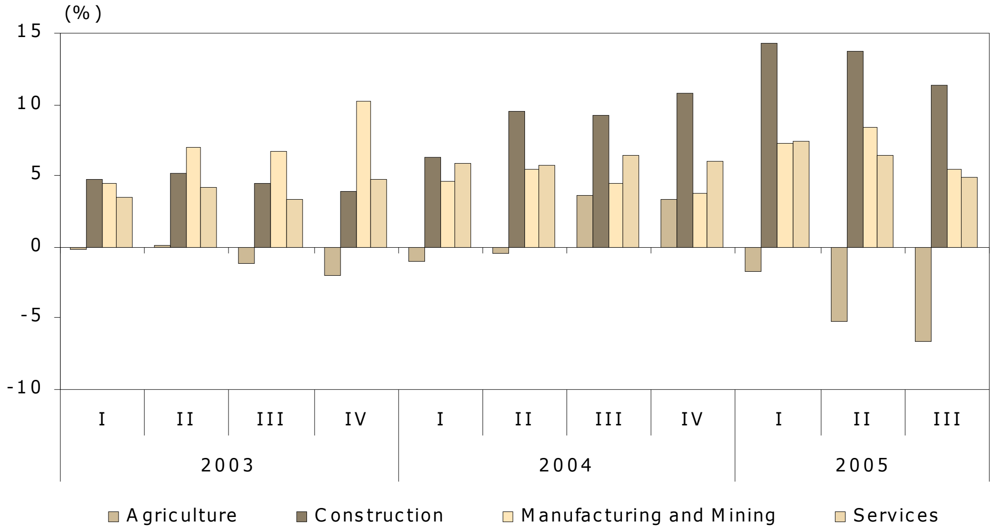
Third-quarter growth in the economy slowed down to 4.6%. The manufacturing sector was again in the lead, though posting a less strong increase in both gross value added (6.5%) and gross output (8.7%) relative to the preceding two quarters. As for the manufacturing industries, it was electricity and heating generation alone that reported a most drastic 12-month decrease not only in value added but gross output as well for a second quarter in a row. At the same time, construction was the most vigorously performing sector reporting a strong increase in both indicators of 11.3 and 14.1% respectively. However, the above growth rates ran well below the pace of the preceding two quarters, with the decline in gross output being all the more pronounced (vs. 26.4 and 24.5% in the preceding quarters). The more or less the same growth rate of gross output and value added evidenced that the sector had reached a certain stage of maturity. Put in more precise terms, it will become more and more difficult to pass the higher input prices in the construction sector onto end-users. Therefore, the following months are also expected to witness some slowdown in prices. Q4 average prices of homes stepped up by only 2.4% on a quarter earlier vs. 11.3% in the same period of 2004. The slower rise in real estate prices indicated that the supply and demand gap was to further narrow down. Having reached some maturity, the sector is anticipated to sustain the growth slowdown in the following months, affecting all up- and downstream industries.

Sales growth in the eleven months to December’05 was mainly due to oil products and non-ferrous metals, accounting for more than half of the sales total in the manufacturing sector. The sale dynamics in both industries was shaped by the favourable terms of trade, promoting exports. 2005 copper prices hit a record high of the past few years, rising by 44.6% in USD terms since the start of the year alone. At the same time, metal production and casting reported the most drastic trend turnaround in the manufacturing sector. While being a major contributor to sales growth in 2004 ferrous metallurgy was now consistently making a negative contribution. Nevertheless, cast iron, steel and ferrous alloy manufactures rebounded in November, lagging significantly behind the 2004 levels, though (November export sales accounted for 45.7% of the sales level on a year earlier, stepping up twofold relative to October). Exports, however, proved to be of crucial importance to the sector’s performance as the production capacity in place exceeded domestic market demands. Therefore, if the recovery of the foreign markets is further sustained, the industry may rebound, making a lower negative contribution to the sales dynamics.

Other industries reporting a significant contribution to growth were as followed: machinery, equipment and home appliances; chemicals and food; and electric machinery and apparatuses. All of them are industries, manifesting a steadier pattern of performance and a higher value added. They are also less susceptible to external factors with the exception of the chemical industry, which depends heavily on the gas price dynamics. The Q4 increase in gas prices may lead to some loss in competitiveness and slowdown in sale growth.

The most robust contribution of 3.1 percentage points to value added growth in the economy was again reported by the service sector, with finance and trade in the lead with 20.1 and 12.4%. The above development was spurred by the strong year-on-year real-term rise in domestic demand of 16.3% in the third quarter. Domestic demand stepped up mainly due to the growing liquidity in the economy having to do with the swift advance of the loan market. As a result, financial intermediaries posted vast amounts of profit, triggering growth in the finance sector. The large amounts of cash in hand and higher propensity to consume led to stronger growth in trade. In addition, the improved standard of living was the main reason behind the restructured household consumption towards a heavier weight of services (8% up). Tourism made again the usually strong Q3 contribution to growth in the service sector. Revenues from tourism stepped up by 10.1% in nominal terms, running, however, some 8 percentage points down on a year earlier due probably to the incomplete construction works in the heat of the holiday season.

Real value added growth by sector of the economy



Source: NSI, AEAF

At the same time, agriculture was the only sector in the economy posting a real-term decline in value added (-6.6% in the third quarter). Its performance deteriorated as early as the start of 2005 due to the chronic problems suffered by livestock production. All this was further reinforced by the summer flood damages leading to lower crop yields as well as higher production costs – intermediate consumption went up by 1.2%, despite the gross output drop. As a result, the profit margin in the sector went on the decrease: value added plunged by 18%[1] whereas the share of gross output stepped down by 5.6 percentage points to 40.4% on a year earlier. However, although livestock production was experiencing severe hardship (but reported a 0.8% real-term increase, though), crop production proved to be the industry contributing (by -6.21 percentage points, or 12.2% at constant prices) in the utmost to the 7.6% 12-month gross output decline in agriculture.

On the demand side, fixed capital formation reported the highest ever real-term rise of 25.4% in the third quarter and 17.7% since the start of the year. Gross fixed capital formation picked up due to the robust importation of investment goods, machinery and equipment in particular, and cars. At the same time, investment in the economy was mostly financed by way of foreign savings, as national savings plunged by 3% in nominal terms on an annual basis. However, government restrictive policies made up, by and large, for the dearth of private savings expected to finance the investment process, reducing the needs for foreign financing to - 7.1% vis-à-vis GDP. Q3 growth was also enhanced by the positive contribution of inventories (4 percentage points). This, however, may reduce the growth potential at some point in the future, given the indicator's structure.

Final consumption also picked up (9.2% in the third quarter) due mostly to private consumption (6.6 percentage points up in the quarter, given a real-term rise of 10.8%). The moderate growth rate of both employment and real income were the major factors at work behind the increased consumption. However, the indicator picked up mainly at the expense of the rising share of loan-financed consumption, through the robust lending activity of banks including. The high share of services used was further sustained at 17.5% of GDP vs. 16.3%

[1] Source: Economic accounts in agriculture, NSI.

on a year earlier. Going up by 13.3% in real terms, the consumption of market produce outstripped total consumption indicating a major improvement in household welfare. At the same time, the contribution of government consumption to growth posted a drastic drop to 0.42 percentage points from 1.5 in the second quarter.

The Q3 contribution of the external sector was strongly negative (-11.1 percentage points) due to the vigorous real import growth (19%), given the same pace of exports in real terms (0.9%). Despite its adverse impact on growth in the quarter, imports are expected to make a healthy contribution in the long term as a result of the strong share of investment goods (10 percentage points) in nominal-term import growth (32.5%), which will in turn augment the GDP growth potential. The weak export growth was triggered by an interplay of price factors at work (the export deflator was down at 8.3% in the third quarter) and was strongly affected by the sky-high oil prices, as evidenced by the export price index of crude oil, refined oil products and gas (57.2 and 37% respectively).

Employment and the jobless rate

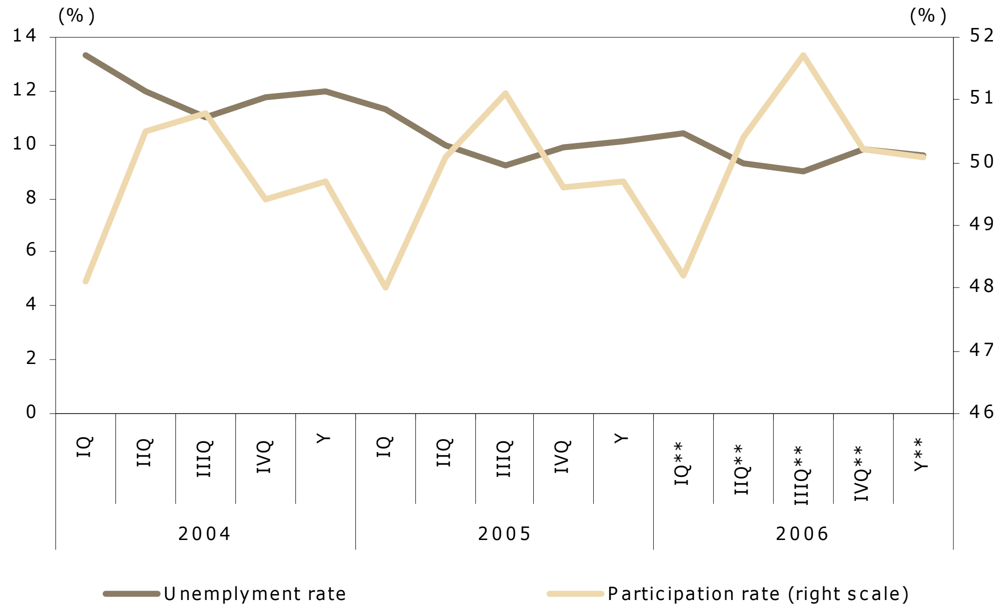
The labour market went on improving in the wake of the strong growth in the local economy of the past couple of years. Following the year-on-year slowdown in the first two quarters of the year, employment went on the increase again and third-quarter employed numbers ran some 2.4% higher relative to the same period of 2004.[2] Employment stepped up mainly as a result of the 5.3% year-on-year increase in private-sector employed of 110 thousand. On the other hand, private-sector employment was promoted by the country’s macroeconomic stability leading to a steady labour market upswing and continuous decline in the jobless rate. Q3 unemployed numbers accounted for 9.2% of the working-age population, going significantly down by 16.1% on a year earlier, whereas the jobless rate ran some 1.8 percentage points lower. The country’s unemployment has stepped down as low as well below 10%, hitting a historical low. The administrative statistics of the Employment Agency reinforced further the labour market developments reported by the Statistical Office. In addition, the government made active use of its employment promotion programmes to avoid the usual downswing in the labour market in October and November. All this made no room for any increase in registered employment, which was steadily declining to 10.4% as of end-November. In December, however, the jobless rate advanced to 10.7% due to the interplay of seasonal factors as well as the termination of temporary employment for many people involved under the government social policy programmes.

Together with the decrease in the jobless rate, the findings of the Q3 labour force surveys also referred to a declining discouraged number (10.1% down on a year earlier). In addition, the aggregate out-of-labour force cohort decreased too by 0.7% in the period surveyed.

The lower discouraged numbers alongside the increase in employment resulted in the first-ever increase in the economically active population since the start of the year. As a result, the country’s labour force in the third quarter went up by 13.4 thousand or 0.4% up on a year earlier, whereas the participation rate in the economy (of people aged 15 and over) hit 51.1%, or 0.3 points up.

[2] According to data of the labour force surveys.

Unemployment and participation rate* in the economy



* of people aged 15 and over
** forecast

Source: NSI, AEAF

Income and productivity

At preliminary NSI estimate, average wages[3] over the July-September period amounted to BGN 320, going up by 8 and 3.1% in nominal and real terms respectively on a year earlier.

The upward trend in household income was also evidenced by the household budgets surveys conducted by the NSI on a monthly basis. Money income per household capita in the third quarter stepped up by 6.6% in real terms on average on a 12-month basis due mostly to the strong contribution of income from employment, entrepreneurship and pensions (reporting a year-on-year real-term increase of 9.9,15.6 and 2.6% respectively). At the same time, according to monthly NSI data, money income per household capita posted an annual rise of about 1.9%.

On a year earlier, Q3 GVA growth per employed in the economy[4] ran at 0.9%. Real average wage growth (3.1%) outstripped productivity. The slower pace of productivity vis-à-vis average wages was by and large due to the agricultural sector and some of the manufacturing industries, e.g. electricity and heating generation and supply, and construction. At the same time, Q3 productivity ran the highest in the service industries well ahead average wages because value added stepped up at a faster rate compared to the employed numbers.

Inflation

In early autumn food prices carried on rising at a pace higher than expected due to the summer flood damages, which in turn made harvesting difficult and led to worsened crop quality. At the same time, some of the food industries (dairy and meat processing) were experiencing raw material shortages as a result of the local undersupply to meet their

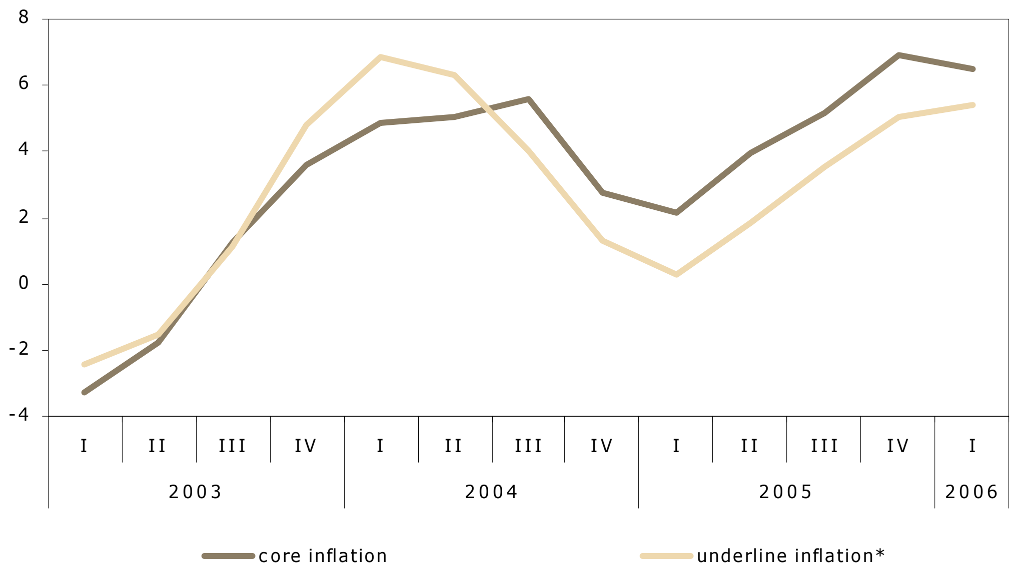
[3] According to survey data on the employed numbers, time worked, wage bill and other labour costs.

[4] Estimated as the ratio of GVA to the employed numbers as per labour force survey data.

demands. In addition, the preferential import quotas negotiated proved to be insufficient to make up for local underproduction. What followed was a significant food price rise in the last quarter of the year. Relative to December'04, food prices stepped up by 6.76%, making a 2.57 percentage contribution to the higher consumer price level.

In August crude oil prices hit a record high worldwide only to go on a steady decline ever afterwards to some USD 55.04 per barrel in November. As a result, local fuel prices over the September-November period went down by about 12%, running, however, still some 27.1% higher compared to December'04. At the same time, propane-butane prices followed a different pattern of dynamics, as they were affected by crude oil prices with a certain lag in time. The gas price increase started as late as September reaching 12.1% in December (period's cumulative). The aggregate contribution of fuels to total price inflation was estimated at 0.87 percentage points.

Quarterly core inflation, y/y



* core inflation, excluding unprocessed food and market-priced energy

Source: AEAF, NSI

Despite the decrease of the last quarter, cumulative fuel price inflation since the start of 2005 led to a 12.55% rise in transport fares on a 12-month basis. On the whole, market service prices advanced by 7.41% relative to December'04, posting a 1.45 percentage point contribution to the country's inflation.

2005 core inflation stepped up as high as 6.54%, pushed up mainly by food, service and fuel prices. However, price volatility excluded, the market price rise since the start of the year amounted to 4.83%, reporting a contribution to overall price inflation of 5.15 percentage points.

On a year earlier, administered prices advanced by 6.14%. The decision of the State Commission on Energy and Water Regulation as to another gas price rise of October resulted in a higher than expected November increase in heating prices for household use. As the prices of water warm-up had already risen in July, the aggrage increase in heating prices to December ran at 20.45%. Medicine prices carried on rising in September and October, reporting a cumulative price change of 10.77%. In December railway fares went on the increase. As a result, administered prices reported a 1.31 percentage point contribution to the consumer price level.

Balance of payments

In the eleven months to December the current account deficit ran well above its 2004 level, accounting for 12.6% of the GDP forecasts. The year-on-year increase was triggered by the robust imports and modest exports in the third quarter as well as the worsening balance on services, having to do with the lower than expected revenue amounts from tourism and ever-growing transport costs. Despite the prevailing upward trend, the current account deficit in October and November deteriorated at a slower pace due to the stronger exports and lower imports.

Imports over the January-November period amounted to MEUR 12251.3, or 27.1% up on a year earlier. However, November witnessed a certain slowdown in import growth due not only to the lower importation of energy resources but investment goods as well. 2005 imports stepped up mainly as a result of the vigorous rise in energy imports of 53% triggered by the higher crude oil prices worldwide. By the end of November oil import prices had gone some 47% up on average leading to MEUR 260.3 worth of deterioration in the current account. Nevertheless, crude oil imports rose by 11.1% in volume terms.

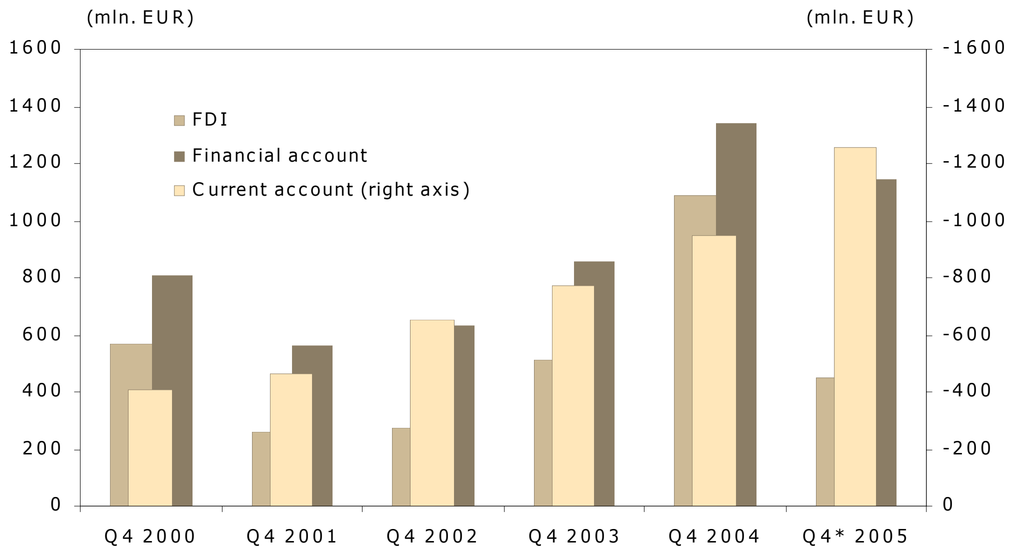
Another reason for the higher 2005 imports had to do with the 19.7% year-on-year increase in the importation of consumer goods, as fostered by the vigorous domestic demand. Cars, food and beverages, cigarettes, furniture and home appliances were the import items posting the strongest rise in the year due to the increased consumer loans extended by commercial banks. However, in the end of 2005 consumer import growth slowed down.

Going up by 18.2%, exports over the January- November period amounted to MEUR 8595.7. As the metal market situation was steadily deteriorating in 2005, cast iron, iron and steel exports went on the decrease. Meanwhile non-ferrous metal exports were picking up throughout the year, accounting for 10% of the export total, due to the growth-conducive price dynamics. Over the same period, raw material items reported an aggregate increase of 16.8%. The ever-growing vehicle exports led to a 33.4% rise in the exportation of investment goods. At the same time, the group enjoying the largest weight in total exports, i.e. clothing and footwear, failed to grow, as it faced the strong competitive pressure on the part of Chinese producers on the EU markets. In October, they reported a volume-term rise on a year earlier, without however indicating any steady turnaround in the trend. The higher prices and volumes of oil product exports boosted energy exports in the last months of the year.

The financial account in the eleven months to December ran positive at MEUR 2852.8 fully covering the current account deficit. FDI over the same period amounted to MEUR 1509.6 and made up for 56% of the negative current account balance. The modest investment influx had to do with the lack of privatization deals in the year (vs. MEUR 381.8 on a year earlier). Revenues from 2004 privatisation excluded, FDI inflows in the eleven months to December'05 stepped up by 31.9%. Greenfield investments[5] went up by 20.9%, with the largest amounts of foreign capital being attracted in the following industries: real estate transactions, lease and business services, financial intermediation, processing, construction, storage and communications.

[5] Estimated as the sum of other capital attracted and reinvested profit.

Financial account, FDI and the current account

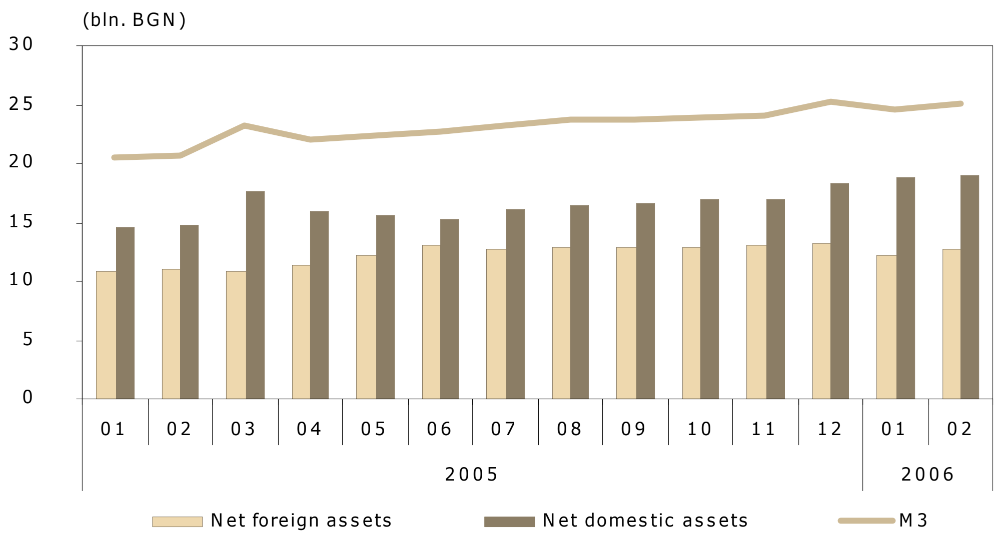


Source: BNB

Financial sector

Relative to end-August, money supply over the September-November period advanced by 1.5% (BGN 346.5 million). Broad money growth was mostly due to the 2.7% increase in quasi money of BGN 318.8 million, as monetary aggregate M1 stepped up by a bare 0.1% (BGN 16.4) as a result of the seasonally dull demand for money for transaction purposes. M3 change in the period surveyed had to do with a significant rise in net domestic assets and a lesser rise in net foreign assets of banks.

Money supply



Source: BNB

Net foreign assets in the banking system stepped up owing solely to the net foreign assets of the Central Bank, which as of end-November ran some 8.2% (BGN 1 bilion) up their end-of-August level due to the third tranche under the World Bank PAL facility and balance of payments surplus in the same period. The net foreign assets of commercial banks reported a 3-month shrinkage of BGN 914.7 million as a result of the contraction in foreign assets as well as the increase in foreign liabilities. Following the sizable net outflows to the external sector in the better half of 2005, in September, October and November local banks started to borrow resources from abroad again while curtailing their foreign assets. Furthermore, as the BGN 540 million worth of time deposits of non-residents ran very close to the difference between the loan extensions[6] in the same time and time deposits of residents (of about BGN 530 million), the underlying assumption here is that bank deposit-taking from abroad was mainly aimed at funding lending.

The 3.5% growth in net domestic assets (BGN 581.9 million) had to do with the BGN 432.3 million worth of drop in bank claims on the government sector and some 6.5% of a rise (BGN 1.1 billion) in the claims on the non-government sector. The lower claims on the government sector were mainly spurred by the WB loan tranche as well as tax revenues, whereas bank claims on the non-government sector stepped up at the expense of the higher household credit (10.1%, or BGN 611.6 million up). Relative to earlier periods, claims on non-financial institutions posted a significant increase of 4.7% (BGN 475.7 million) altogether. This was by and large due to the ceased bank practices to sell some part of their credit portfolios to non-residents, which last took place in September.

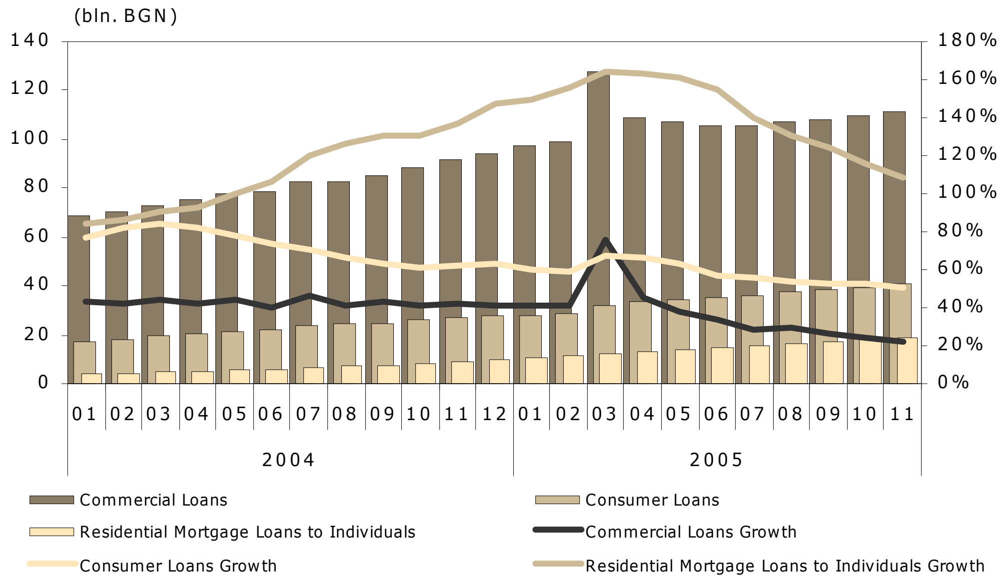
Banking sector

2005 saw some slowdown in credit growth in the wake of the latest BNB measures. In the eleven months to November, loan extensions (to non-financial institutions and other customers) advanced by 27.8% (vs. 42.8% on a year earlier). At the same time, the consolidated balance sheet of commercial banks reported some decrease in credit growth, which was, however, due to the portfolio work-out effort on the part of banks aimed at bending the lending rules in place. Most commercial banks opted for selling corporate credit to their major shareholders, making extra room for a further loan portfolio increase while abiding by the Central Bank’s credit restrictions.

Trade credit growth slackened vis-à-vis the other loan products, which may at some point have a curbing effect in the economy, provided enterprises fail to find alternative sources of financing. Investment needs in the last couple of years have been met by the non-resident sectors (mainly in the form of trade and intra-firm credit), which led to a sizable increase in the private-sector foreign debt. The bulk of these liabilities had to do with FDI inflows into the country, augmenting production capacity in the economy and improving borrowers’ ability to meet outstanding debt. In October gross foreign debt reached EUR 13.4 billion, going up by 6.6% on a year earlier. The private-sector foreign debt rose by EUR 2.25 billion, whereas the foreign debt of the public sector declined by EUR 1.416 billion.

[6] Loan extensions do not include overdraft credit and credit to financial institutions.

Trade, consumer and mortgage loan dynamics



Source: BNB, AEAF

On a year earlier, consumer loans in the September-November period stepped up by BGN 334.4 million relative to end-August (vs. BGN 275.1 million in the same period of 2004) while mortgage credit grew by BGN 232.5 million (vs. BGN 189.4 million in the same period of 2004). Data on the consumer loan market of the last months of 2005 question the effectiveness of the Central Bank's restrictions, especially if they had been taken to cut down the current account deficit.

Over the period surveyed, the deposits of non-financial institutions and other customers gained further importance. Rising by BGN 652.1 million, they made up for 71.8% of the credit growth reported (vs. 70.2% in the same period of 2004). The deposits of financial institutions, which were essentially non-resident banks' placements, made again an important contribution, though diminishing in importance compared to the first quarter of 2005. They played an essential role when banks embarked on large-scale lending in March to avoid BNB credit growth ceilings announced a month earlier. In the months to follow, however, bank credit portfolios stepped up mainly as a result of the deposits of residents taken.

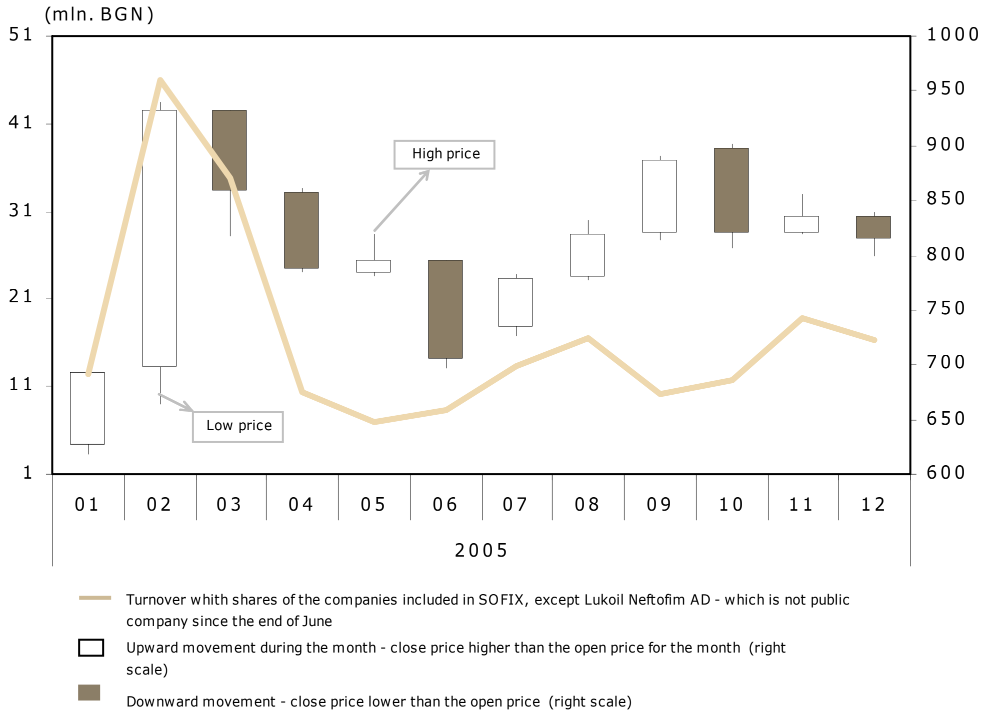
As of end-November, commercial banks went on posting large net profits (31.2% up on a year earlier). The bulk of the profit reported was due to net interest income (a y/y increase of 30%). The credit growth restrictions and higher incentives for deposit-taking affected bank profitability, as most profitability indicators deteriorated relative to the same period of 2004. The net interest income/average size of assets ratio went down to 4.3% (vs. 4.6% as of end-November'04), whereas the ratio of net profit to average assets declined to 2.2% vs. 2.5% in November'04.

Banks carried on lowering credit interest, with a more significant decrease being reported by long-term loans in BGN. As of end-November and early December, loan interest, in particular interest on short-term loans in EUR, advanced insignificantly, having to do with expectations of a certain rise, and consequently with the increase itself in the ECB refi rate of the beginning of December.

Exchange rate trading

Having steadily advanced throughout July to September, SOFIX went on the downswing in the last quarter of 2005, with the amplitude of fluctuations being smaller and price corrections smoother since share price dynamics had already, supposedly, reached a point of equilibrium. The Q3 financial statements of end October and early November did not provide for the sustainable growth of the preceding months as well as for overcoming the level of 900 points, though indicating on the whole a rather strong financial performance of the companies listed. Judging by the items in the SOFIX make-up, the market had geared itself to the turnaround in the upward run until February to manifest steady performance ever afterwards. While plunging in the second quarter relative to the preceding periods of growth, Q4 trading turnover remained almost unchanged at the levels on a quarter earlier due probably to the price equilibrium reached, as there were not any clear incentives for upward or downward movement. However, the news that may upset the equilibrium achieved may come along the lines of last year's non-consolidated non-audited financial statements of the listed companies to be released at the end of January'06. Furthermore, stock exchange trading will be mainly shaped by news about the final decision of the EC as to the country's date of accession to the Union in the spring when the audited financial statements are to be published. Therefore, for this and other reasons the first quarter is expected to sustain the price dynamics of the preceding half-year period, without any significant up- or downward break-through.

Trading turnover and SOFIX dynamics



Source: BSE, AEAF

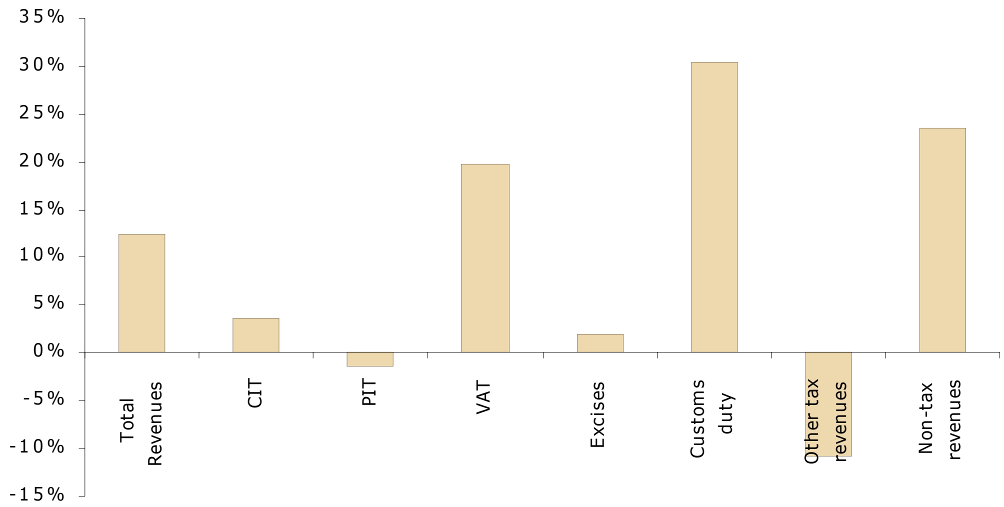
Government budget

The consolidated budget surplus carried on rising in the September-November period, despite the usually modest revenue performance in these months. The cash balance in the eleven months to December stepped up as high as BGN 1.8 billion or 4.3% of the 2005 GDP forecasts, allowing for some BGN 675.7 million (14.5%) worth of an increase in the fiscal reserve account as of end-November, relative to the end of August.

The accumulated amounts on the fiscal reserve account made end-of-year foreign debt repayments (the country effected an ahead-of-schedule payment worth MEUR 150 to the IMF) possible without affecting the budget financing exercise. As a result, government debt was to contract to about 32% of GDP as of the year's end.

On a year earlier, budget revenues in the September-November period improved by 11.3%, with this strong performance being solely due to VAT revenues. The steady and vigorous import growth resulted in a robust rise in revenue from both VAT (19.7%) and customs duties (30.5%) in the same period. The relatively high oil prices worldwide were one of the factors at work behind the stronger revenue amounts from VAT and customs duties, the aggregate effect of which was estimated at around BGN 20-30 million. On the other hand, revenues from excise duties stepped up by only 2% following their vigorous performance of the summer months due mostly to fuel price fluctuations. The early-2005 alleviation in the direct tax burden affected tax revenue performance rather strongly. The high increase in the taxable corporate income secured some 3.6% of a rise in revenues, despite the lower tax rate. On the other hand, the revenue amounts from the personal income tax declined by 1.5% in September to November due to tax rate amendments. Non-tax revenues stepped up by 23.6%, with the largest contribution being made by budget receipts from government fees and charges. Technically speaking, the vast revenue amounts had to do with the sale of third-generation mobile service licences.

12-month growth by revenue item in the September-November period.



Source: MoF

Consolidated budget expenditures advanced by 7.5% in the period surveyed due mainly to the higher spending on maintenance costs, and social and capital expenditures, whereas subsidy allocations decreased. Higher budget spending on maintenance and wage bills had to do with the administrative capacity reinforcement effort while social expenditures went on the increase in the wake of a package of administrative measures, raising the pension ceilings.

Forecasts

External environment

The oil market interventions conducted by the International Energy Agency in the wake of the Katarina devastation resulted in a market repose and hence a price drop. What followed was a fourth-quarter decrease in average oil prices to USD 56.6 per barrel. Although, at WB estimate, 2006 prices are to steady at around USD 56 per barrel, the current forecasts draw upon more conservative expectations. Market insecurity remains rampant and rules out any significant drop off the current levels.

The oil price rise of end-August made inflationary expectations even stronger and Euro area inflation advanced to 2.6% in September and October, bringing about a 0.25 percentage point increase in the ECB refi rate. Given the above developments, AEAF estimates of Euro area interest rates have been revised upwards by 0.3 percentage points vis-à-vis earlier forecasts.

The oil price dynamics had a similar effect on the interest rate policies of the Federal Reserve. Although inflation (volatile prices excluded)[7] had become stable by the end of the second quarter, the record high increase in oil prices sent annual inflation in October and November up at 4.7 and 4.3% respectively. All this forced the Feds to pursue a gradual increase in the Fed fund rate, without missing the scheduled dates. As a result, interest rates stepped slightly up compared to earlier estimates.

The USD/EUR exchange rate dynamics is difficult to forecast. Some analysts are of the opinion that the single European currency may step up as high as USD 1.30 while other believe that it may as well plunge to USD 1.08. The reasons for a likely appreciation of the EUR in 2006 have to do with the huge US trade and budget deficits as well as the policies to be pursued by the Federal Reserve, following the change in governor’s office. The above fears are further reinforced by the significant increase in USD interest rates and expectations that ECB is to effect a series of rises in interest rates. At the same time, the strong performance of and higher interest rates in the US economy may make the EUR cheaper.

Current estimates do not provide for any substantial rise in USD interest as in 2005. All this, together with the anticipations of a smooth increase in the Euro area interest rates are to keep the interest rate spread stable, somewhat favouring the USD’s appreciation on a yearly average in 2006.

Furthermore, current projections rely on earlier assumptions as to real growth in the Euro area of about 2%, promoting Bulgaria’s export performance.

GDP

The weaker Q3 exports led to lower than expected GDP growth over the same period. All this called for some downward revisions in the 2005 GDP forecasts by 0.2 percentage points to 5.4%.

Based on the NSI budget household surveys, the growth estimates of final consumer spending have been amended and Q4 consumption growth has been revised upwards by a solid percentage point. The robust investment activity in the nine months to October made analysts adjust their Q3 investment growth forecasts upwards by 2.5 percentage points. Following the poor performance in the third quarter, October and November exports rebounded, going up by 0.4 percentage points against earlier projections. The increased

[7] Food and energy goods excluded.

growth in the demand components resulted in higher imports, which together with the nominal growth restructuring from a deflator to real-term growth pattern led to a 2.9 percentage point rise. Despite the real-term increase in all components, price restructuring resulted in a slightly lower real growth in GDP in the fourth quarter.

2005 forecasts underwent some revisions having to do with Q3 reporting data. Apart from the lower exports, inventory change was another factor affecting preliminary 2005 estimates. As currently the reason they went on the increase is not clear, inventories are not expected to report a Q4 shrinkage. However, drawing upon sales statistics, inventory change in the fourth quarter is to run at some BGN 300 to 400 million, accounting for 4% of GDP on an annual basis.

2006 is expected to sustain the strong performance of the Bulgarian economy of the last couple of years, without witnessing any drastic year-on-year change in GDP (estimated growth of around 5.5%), as growth will be mainly pulled by consumption and net exports. At the same time, final consumption is to step up at a moderate pace, making a contribution to total growth of some 4.2 percentage points. The strong country's export performance having to do with the improved competitiveness in the economy will lead to a stronger contribution of net exports of around -1.4 percentage points vs. -5.9 in 2005. At the same time, the 2006 pace of inventory growth is to slow down, curbing, in turn, the growth potential of total investment, whose real-term increase is to run slightly below 10%. Although, real-term estimates did not undergo tremendous revisions, the higher average annual inflation will affect nominal statistics, leading to some BGN 200 million higher GDP in 2006 vis-a-vis earlier forecasts. The adjustments to the quarterly breakdown of real growth rates, shown in table 1, were mostly due to the altered 2005 weight estimates at average annual prices, following the release of Q3 reporting data.

Labour market

The 2005 labour market upswing is expected to persist well into next year. As the third quarter saw a better than expected development in employment and the jobless rate, Q4 and 2005 forecasts had to be revised. End-of-2005 unemployment rate[8] is anticipated to go up to about 10.1% of the workforce due to the usual shrinkage in employment, providing less job opportunities in the economy. The narrowed scope of the active labour market programmes of the government is expected to lead to a slowdown in the country's employment to about 2% on an annual basis.[9] The improved performance of the indicator in the second half-year period could not make up for the relatively sluggish increase in the employed numbers in the first six months of the year, as it was coupled with a fast decrease in the jobless numbers. As a result, the participation rate in the economy is anticipated to remain unchanged on a year earlier at around 49.7% on average. 2006 employment is to carry on rising though at a slower pace of about 1% on a yearly average because the scope of the active labour market programmes is to be further narrowed. Therefore, employment will grow mainly due to private-sector job creation. At the same time, the jobless rate is to decrease (to 9.8% on an annual average, running some 0.4 points down on a year earlier) as a result of the strong demand upswing in the primary labour market and job creation. Furthermore, creating sustainable employment in the economy means pushing the participation rate[10] up by around 0.4 points to 50.1% on a 12-month average, relative to 2005. The higher participation rate has to do also with the assumption that the discouraged numbers will carry on declining and join the labour force cohort again.

The fourth quarter is to sustain the growth rate in both average wages and productivity. However, due to the robust performance of the private sector productivity in the next few

[8] By definition of ILO.

[9] Employment estimates are based on labour force survey data.

[10] Of people aged 15 and over.

years is to step up at a faster rate vis-à-vis the 2000-2004 period's average, fostering real income growth in the economy. As for 2006, productivity is expected to outstrip real average wage growth.

Inflation

2006 inflation forecasts take into account the excise duty amendments made. Market prices are expected to advance by 2.40%, whereas the year-on-year rise in fuel prices is to run at 0.23%. The less strong increase against the rise in excise duty rates is due to the assumption that the year is not to see any drastic growth in prices worldwide. Market service prices are to advance by 6.22% due to the indirect effect of the higher energy prices in 2005. Food prices are expected to step up by 1.46%. The contribution of market prices to total inflation is estimated at 1.89 percentage points.

The 2006 increase in administered prices is expected to run at 16.63%, with the strongest rise of 65% to be posted by tobacco prices as a result of the early-year increase in excise duty rates. Heating, electricity and water supply prices are also to step up. The aggregate contribution of administered prices to the country's price inflation in the year is to amount to 3.54 percentage points.

End-of-2006 inflation is expected to run at 5.43%, whereas prices are to report a 7.19% year-on-year rise.

Balance of payments

The 2005 nominal-term export growth is to slow down to about 18%, whereas imports are to step up to 26-27%, as a result of which the country's trade deficit is expected to go up as high as 19.4% of GDP. The current account deficit is to account for 14.5% of GDP, further deteriorating against October estimates (12.4%). The revisions in the AEAF forecasts were mainly due to the changed expectations as to the country's foreign trade, on the one hand, and weaker increase in revenues from tourism and private transfer inflows, on the other.

The 2005 trade deficit estimates have been revised following the manifestation of the adverse effect on the country's export performance of some exogenous factors such as: the Q3 agricultural output shrinkage in the wake of the summer flood damages suffered by the sector, loss of competitive advantages by the local textile industry as well as the drop in some raw material export items (e.g. tobacco, cast iron, iron and steel). At the same time, the revisions as to imports take into account the robust investment activity and strong consumer demand as well as the price dynamics of some of the main commodities.

According to 2006 projections, exports are to step up by 13% in real terms due to the faster growth rate in the EU economy and follow-up increase in foreign demand and improvement of local manufacturers' competitiveness. At the same time, imports will carry on advancing under the impact of the higher spending on consumption, investments and exports, going up by about 11% in real terms.

The aggregate price effect on trade is based on expectations of a lower USD's depreciation to the single European currency, a more modest Q1 increase in crude oil prices relative to the preceding two years as well as a slight drop in metal prices. As a result, the export and import deflators are to run well below their last year's levels while being revised insignificantly upwards to about 4% vis-à-vis earlier forecasts. The nominal-term growth in the respective trade flows is to hover around 18 and 15%, whereas the trade deficit is expected to remain more or less unchanged at 19% of GDP.

The lower than expected 2005 revenue amounts from tourism were the main reason why net services covered only 13% of the country's trade deficit. However, the improved terms of business in the sector as a result of the investments made and equal pricing of the services rendered to both local and foreign holiday makers will bring about some 17% of a rise in revenues, pushing the above ratio up in the same proportion. At the same time, net current transfers are expected to make up for about 25% of the trade deficit. Current private transfers, the growth of which will be up at 10%, and the MEUR 400 of pre-ins planned, are the two current account items curtailing its deficit while generating stronger importation of both consumer and investment goods in the short run.

The income balance will be again the factor at work behind the ever-worsening current account deficit due to the increased foreign ownership in the country and follow-up rise in interest payments on intra-firm indebtedness and dividends to foreign owners.

2006 will sustain FDI growth rather high at about 25%, which together with the nearly MEUR 400 worth of privatization deals in the year, are expected to cover around 80% of the current account deficit, or slightly over 20 percentage points up vis-à-vis the preliminary 2005 estimate. Despite the turnaround in the tendency of FDI to provide for the deficit on their own, the financial account balance alone will do for the shortfalls. The Central Bank's restrictive measures on lending will go on influencing the sources of bank foreign financing, whereas the non-financial sector will keep on borrowing from foreign banks, despite the rise in the interest rates worldwide expected.

The current account deficit expected will be mostly due to the enormous trade deficit. Whether or not it can put the economy at risk depends on a number of factors. On the one hand, it is the robust private consumption that generates the vigorous importation of consumer goods as a result of the income growth and development of the loan market. On the other, the sizable investment inflows into the country alongside EU transfers promote the importation of investment goods, which will, in turn, augment the production capacity in the economy, hence exports in the long term. And last but not least, the pursuit of tough fiscal policies and ever-rising BNB FX reserves will go on functioning as stabilization anchors under the currency board arrangement.

Financial sector

The expectations of the 2006 growth rate of money supply as of the year's end amount to 19%. The estimates take into account the increase in BNB FX reserves anticipated, making also room for assumptions that, first, bank lending will not go in excess of the credit restrictions, and second, that banks will remain net deposit- takers (from non-residents), putting the brakes on net foreign assets in the banking system. The reason why the local banks have tended to attract resources from abroad has to do with the anticipation that nominal-term growth in residents' deposits will lag behind loan growth.

In the second half-year period of 2005, all loan interest rates but housing credit interest (which hit a record low in the year's end) remained relatively stable. Furthermore, 2006 is not expected to witness any decline in interest due mainly to the lower lending activity of banks and certain deterioration in the credit portfolio quality. Loan interest is expected to run close to the end-of-2005 levels, whereas time deposit interest will remain unchanged.

Credit growth by the end of 2006 is to remain within the bounds of the restrictions laid down in BNB Regulation #21, slowing down due to fears that credit portfolio quality may worsen drastically as well as due to the vast amounts on the minimum required reserves to be deposited with the Central Bank, have commercial banks surpassed the credit growth ceilings set out by the latest amendments to the banking regulations. In 2006 again household loans are expected to report the highest increase, with mortgage credit in the lead. On the whole, however, the growth rates of the different components of private-sector credit are to carry on declining.

Government budget

Revenue performance in the period surveyed did not call for any significant adjustment in 2005 and 2006 forecasts. However, some revisions were made in the revenues amounts from indirect taxes, having to do with the stronger receipts from the excise duties on fuels in the last month of the year.

The higher than expected revenue from excise duties last year called for revisions in the 2006 estimates. Whether the above forecasts will come true depends largely on the magnitude of effect of the tax amendments on budget revenues. Q1 performance is expected to remain modest due to the fuel excise duty refunds of December. In addition, revenues from excise duties may slow down as the new excise labels of cigarettes were introduced at a later date and come back to their normal performance not earlier than March. The sharp increase in the excise duty rates on cigarettes and spirit drinks will nevertheless contribute to revenue growth in the year, which is expected to go some 18% up vis-à-vis earlier projections. As a whole, indirect tax revenues are to step up by 11.6%, drawing upon forecasts as to a relatively high, though declining, growth rate of consumption and imports. As for personal income tax revenues, they will be mostly shaped by the amended tax brackets and family income taxation to be applied. According to MoF data, the aggregate burden of the tax amendments will amount to some BGN 250 million of a loss for the budget, with the revenue total in the year going down by 1.9%. 2006 non-tax revenues are expected to manifest a different pattern of dynamics, as in 2005 their performance was further reinforced by the sale of licences of third-generation mobile services and some state property. Since these were one-off amounts, the 2006 budget is not to rely on such strong payments. The expectations are that the robust reserves on the revenue side (of non-tax, personal income tax revenues and social insurance contributions) will turn into a surplus at the year's end, provided tough fiscal policies are further pursued because the 2006 budget is a balanced one.

Forecast errors

- Forecasts do not take into account the likely effect of any follow-up measures of the Central Bank to restrict lending.

- Present estimates do not accommodate a possible increase in the imputed rental value of owner-occupied housing, hence the deflator, which may, in turn, lead to a higher nominal GDP.

- Oil price dynamics remains a major source of forecast errors.

- Electricity and heating price change may live short of current expectations.

- Food price inflation may go on the increase and gross value added decrease depending on the 2006 crop yields.

- A likely change in metal prices in the markets worldwide may affect value added growth in the economy resulting in a different nominal GDP along the lines of exports.

- Lower economic growth in Bulgaria's major trading partners is to result in weaker foreign demand, hence a lower GDP growth rate in the local economy under an ever-worsening trade balance.

- Larger than expected USD/EUR exchange rate fluctuations are likely to affect short-term forecasts.

Tax policy implications in 2006

The fiscal policy amendments of end-2005 were mainly aimed at further improving the terms of business in the economy while sustaining a balanced budget. The most important amendment applied to the social insurance practices in place, providing for a significant decrease of six percentage points in the contribution rates under the first pillar of the pension insurance system and a 1% increase in the amounts to be paid under the second pillar. The aim of the exercise was to reduce the social insurance burden in total wage bill costs met by entrepreneurs as well as to raise the contribution rate of additional compulsory pension insurance and thus strengthen pension insurance fund capitalization (by altering the payment amount shared by employers and employees to 65:35, as envisaged in the social insurance restructuring schedule).

As a result, the contribution amounts were so altered as to favour employers while alleviating the social insurance burden shouldered by employees by a bare 0.025 to 12.425%. At the same time, there are some upbeat expectations that some portion of the decreased wage bill costs will be used to raise gross wages, but whether or not this will be done in practice is still unclear. Passing some part of the insurance contribution from employers to employees in the past did not necessarily mean any notable increase in wages, at least according to the official NSI statistics.

In 2006, the aggregate tax insurance burden on income is to decline due to the amendments to the tax brackets. The increased non-taxable income to BGN 180 as well as the removal of the first tax bracket are expected to result in lower tax liabilities for all income groups, with the decrease (3.2-3.5%) being most significant for the group reporting income of BGN 200 and 250.

Another important fiscal policy amendment had to do with the sharp rise in the excise duty rates on cigarettes and fuels made in line with the country's accession commitments. Having started to apply the EU minimum, the Ministry of Finance plans another increase in the duty rates on cigarettes as late as 2010. The earlier implementation of the above measure was aimed at reducing the pro-inflationary pressure of the higher excise duty rates expected in 2008 when the country will have acceded to EMU II and will have to fulfil the Maastricht criteria by maintaining a rate of inflation not higher than 1.5 percentage points of the indicator's average in the three member states reporting the highest inflation.

The assessment of the combined effect of the tax amendments comes to different policy implications. On the one hand, the reduced tax burden boosts household income growth and promotes business activity. On the other, the higher excise duty rates have the opposite effect. AEAF analysts have applied a simulation model, exclusively focused on 2006, to examine the impact of the tax policy changes on the economy without estimating the likely effects for following periods.

The findings imply that the combined effect of tax policies will have a positive contribution to 2006 GDP growth of 0.2 percentage points, with the largest weight in this growth being enjoyed by investments, as spurred by the lower social insurance payments. Investments are to step up by 1.7 percentage points, whereas consumption is to rise by 0.2 percentage points, suggesting that the effect of the alleviated tax burden will dominate the effect of the higher excise duties. It follows that while households will be favoured by the lower income tax rates, the excise duty increase will have an adverse effect on consumers alone. Wage growth is to advance by 0.2 percentage points vis-à-vis the base-case scenario due mainly to the mobilization of resources made available from the lower social insurance payments to be made by employers. Furthermore, the aggregate rise in domestic demand will put an upward pressure on the country's trade balance, hence the current account. Imports are to be further boosted by 0.5 percentage points in comparison to the base-case scenario, whereas exports are to remain unchanged due mainly to the time lag in the manifestation of the effect (so that the boosted by the lower taxes investment activity to spur production and hence exports in the years to come). This, however, is an assessment that goes beyond the scope of the present survey. The current account balance is to worsen by another 0.3 percentage points of GDP as result of the lower tax rates on income.

The tax policy amendments will have a most tangible effect on the country's inflation rate, as the contribution of the higher excise duty rates is estimated at 2.3 percentage points.

As for employment, providing incentives to employers by reducing the social insurance contribution rate will come down to a slight increase in employment of 0.1 percentage point but a proportionate decrease in the country's jobless rate as well.

The effect of the tax amendments on public finance is not unequivocal either. The overall revenue loss as a direct result of the tax rate changes has been estimated at BGN 812.4 million. The budget, however, will be able to recover some portion of the loss in the form of BGN 50.4 million worth of additional revenue amounts (from VAT and the corporate tax mostly) due to the faster economic growth expected. At the same time, budget spending is to go on the increase (0.5% up), as some expenditure items, pension payments and maintenance costs, have been updated to meet the higher price level. The aggregate effect on the cash balance is to run negative at about BGN 840 million, leaving little room for the budget authorities to maintain the same surplus as in 2005.

Table 1

Macroeconomic Indicators 2004 - 2006																				
		Reported data			Forecasts															
		2004	Q1	Q1	Q3 2005		Q4 2005		2005		Q1 2006		Q2 2006		Q3 2006		Q4 2006		2006	
			2005	2005*	forecast	reported	previous	revised	previous	revised	previous	revised	previous	revised	previous	revised	previous	revised	previous	revised
Exchange rate USD/BGN, p.a.		1.6	1.49	1.55	1.60	1.60	1.59	1.66**	1.56	1.58**	1.60	1.64	1.61	1.66	1.62	1.67	1.63	1.66	1.61	1.66
Petroleum spot price (APSP)		37.8	46.2	50.8	60.0	60.0	61.5	56.6**	54.6	53.4**	62.3	59.3	62.0	58.0	61.8	58.5	61.0	58.0	61.8	58.4
EU Area Real GDP growth	%	1.7	0.6	1.6	1.8	1.4	2.1	2.1	1.5	1.5	1.7	1.7	2.0	2.0	2.2	2.2	2.3	2.3	2.1	2.1
LIBOR U.S. dollar deposits	%	1.9	3.1	3.5	4.0	4.0	4.3	4.5**	3.7	3.8**	4.4	4.7	4.5	4.8	4.6	5.0	4.6	5.2	4.5	4.9
GDP, current prices	mln. BGN	38 008	8 690	9 738	11 650	11 619	11 460	11 509	41 536	41 555	9 774	9 730	10 672	10 728	12 991	13 094	12 585	12 650	46 022	46 201
GNP, current prices	mln. BGN	37 342	8 386	9 554	11 243	11 298	11 373	11 385	40 555	40 676	9 504	9 386	10 429	10 486	12 597	12 657	12 480	12 448	45 015	44 978
GDP, real growth	%	5.6	6.0	6.4	5.5	4.6	5.1	4.9	5.6	5.4	4.9	4.9	5.2	5.7	6.2	6.0	5.3	5.0	5.5	5.5
Consumption, real growth	%	5.0	7.3	5.9	6.1	9.2	5.0	6.0	5.9	7.0	4.3	3.9	5.0	5.0	4.7	4.2	4.4	5.3	4.7	4.8
Investment, real growth	%	14.8	8.5	22.2	15.6	43.3	11.6	14.1	14.5	22.0	11.0	12.0	8.5	8.0	8.7	6.7	9.3	11.8	9.3	9.5
Exports GNFS, real growth	%	13.1	8.8	12.0	9.8	0.9	9.0	9.4	9.9	7.2	11.5	12.5	11.8	11.4	11.9	14.8	12.8	9.4	12.0	12.1
Imports GNFS, real growth	%	14.1	10.8	15.5	14.3	19.0	10.5	13.4	12.8	14.8	11.0	11.8	11.2	10.2	11.0	12.1	11.0	11.0	11.1	11.3
Inflation, corresponding period of previous year = 100	%	4.0	2.0	1.2	3.2	3.3	5.1	6.45**	5.1	6.45**	4.1	3.9	2.3	2.1	3.7	3.8	5.2	5.4	5.2	5.4
Inflation, previous year = 100	%	6.2	3.6	4.4	4.3	4.4	6.5	7.77**	4.7	5.04**	6.4	7.3	5.9	6.8	5.5	6.2	7.3	8.5	6.3	7.2
Core inflation, corresponding period of previous year = 100	%	4.6	2.2	4.0	5.2	5.2	5.7	6.91**	4.3	4.54**	5.6	6.7	4.2	5.2	3.3	4.3	2.9	2.7	4.0	4.7
Administrative prices, corresponding period of previous year = 100	%	11.0	8.7	7.7	3.8	4.0	4.2	5.85**	6.1	6.54**	14.6	16.7	13.4	15.5	15.2	16.3	14.7	17.1	14.5	16.4
Current account balance	mln. EUR	-1 447	-708	-735	-161	-422	-1 034	-1 257	-2 638	-3 086	-672	-728	-774	-813	172	-235	-1 135	-1 500	-2 408	-3 276
Current account balance, % to GDP		-7.4	-15.9	-14.8	-2.7	-7.1	-17.6	-21.4	-12.4	-14.5	-13.4	-14.6	-14.2	-14.8	2.6	-3.5	-17.6	-23.2	-10.2	-13.9
Exports	mln. EUR	7 994	2 078	2 304	2 599	2 414	2 665	2 629	9 645	9 429	2 483	2 534	2 668	2 691	2 962	2 951	3 007	2 919	11 120	11 095
Imports	mln. EUR	10 712	2 729	3 346	3 426	3 515	3 843	3 966	13 345	13 558	3 222	3 287	3 816	3 890	3 802	3 991	4 302	4 472	15 142	15 641
M3, p.a.	mln. BGN	18 033	21 488	22 407	23 480	23 540	24 577	24403**	22 978	22960**	26 951	26 731	27 885	27 930	30 054	30 188	31 122	31 181	29 003	29 008
Reserve money, p.a.	mln. BGN	5 505	6 622	7 060	7 483	7 611	8 331	8043**	7 272	7334**	8 192	8 125	8 324	8 337	9 392	9 434	10 105	10 124	9 003	9 005
Total revenues	mln. BGN	15 855	4 167	4 678	4 343	4 396	4 811	4743**	17 998	17983**	4 353	4 293	4 907	4 789	4 716	4 589	5 191	5 078	19 166	18 749
Tax revenues	mln. BGN	12 774	3 404	3 530	3 563	3 594	4 010	3956**	14 507	14484**	3 644	3 563	3 806	3 829	3 869	3 803	4 293	4 232	15 612	15 427
Unemployment rate	%	12.0	11.3	10.0	9.8	9.2	10.9	10.1	10.5	10.2	10.8	10.8	9.7	9.8	9.3	9.0	10.0	9.7	10.0	9.8
Participion rate	%	49.7	48.0	50.1	50.7	51.1	49.4	49.6	49.6	49.7	48.4	48.3	50.7	50.6	51.2	51.7	49.7	49.8	50.0	50.1

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

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